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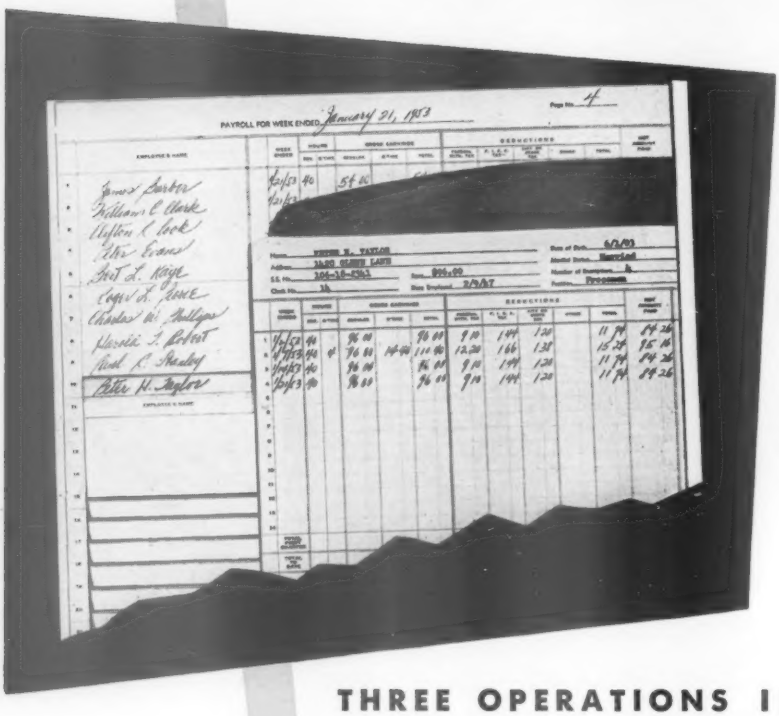

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1954 Code can turn buy-sell agreements into disastrous tax traps for stockholders

by ARNOLD J. HOFFMAN

The stock-attribution rules of the new Code may produce dividend income where capital-gains treatment has heretofore been expected. This disastrous situation results from the involuntary operation of a buy-sell agreement, probably one written before, or in ignorance of, the new Code. All pre-1954 buy-sell agreements should be examined at once to guard against this threat. This article discusses recent Revenue Ruling 56-103, which sets forth the IRS position, and explains the operation of Sections 302 and 318 which cause the trouble. The author gives brief suggestions for avoiding this tax catastrophe.

MANY TAXPAYERS have a vague idea that the 1954 Code provides generally that in certain situations redemptions will be treated like dividends. Many have no realization as to how technical and complicated are the provisions added by the new Code; in particular, the constructive stock ownership rules. These rules set up one of the most dangerous tax traps we have ever had. Today, if in a closely-held corporation there is an agreement forcing a deceased stockholder's estate to sell stock to the corporation, the agreement may constitute a time bomb—set to explode when the stockholder dies. The result can be disastrous at today's tax rates. The estate may *have* to sell—the new tests and constructive stock ownership rules may label the redemption a *dividend*—and the federal government may take *most* of the proceeds.

To determine whether you are safe, it is not enough to look only at the buy-sell agreement. Today it is necessary to look closely at the stockholders, their identities, relationships, and relative holdings. Are they members of the same family? Are they or will they be beneficiaries of the same estate? Are they or will they be beneficiaries of the same trust, and if so, what is or will be the actuarial interest of each? Are they co-partners in a partnership? Are they co-stockholders in another corporation?—and so forth. All of their relationships and interests must be checked for trouble spots. In order to understand thoroughly the implications of this trap, let us examine the operation the law before going into the details, later in this article, of the buy-sell agreement problem. The dangers can be spotlighted best by a few simple concrete illustrations.

Several years ago a husband and wife formed a corporation. Each put in $50. Each took 50 shares. The corporation has accumulated $500 of earned surplus. Each share is now worth $6; their tax basis is $1 per share.

Suppose the wife turns in her 50 shares for $300. Would the redemption be treated like a sale, or like a dividend? For the answer, we must turn to Section 302 and its three tests. See box on page 324 for an example of how this section works.

But we can't stop at Section 302—we must consider also Section 318. Here a complication, new in the 1954 Code, enters the picture. Section 318 adds constructive stock ownership rules under which taxpayers are to be treated as if they owned stock held by cer-

tain other taxpayers. One of those rules, in effect, states, "A person will be treated as owning all of the stock owned by husband or wife, parents, children, or grandchildren."

Applying that rule, the wife is considered to own her husband's 50 shares. Therefore, we begin with the wife actually owning 50 shares, and being considered to own also her husband's 50 shares. Hence she is treated as if she owns 100 shares.

Her 50 shares are redeemed. After the redemption, she is still treated *as if* she owned the 50 shares owned by her husband. So this wife is regarded as if she were a 100% stockholder *before* the redemption, and a 100% stockholder *after* the redemption.

Application of the three Section 302 tests

What happens to Section 302 and its three tests under such a stock ownership rule?

Test one: The redemption will be treated like a sale if it is not essentially equivalent to a dividend. Here the wife is regarded as if she were always the sole stockholder. The redemption appears then to be equivalent to a dividend, and the test is not met.

Test two: The redemption will be treated like a sale if it is a substantially disproportionate redemption, substantially reducing, in a specified manner, the proportionate interest of the wife. Under this stock ownership rule her interest is never reduced. She is always regarded as having a 100% interest. This test is not met.

Test three: The redemption will be treated like a sale if it completely terminates the stockholder's interest. If under the family ownership rule she is treated as owning her husband's shares, her interest is not terminated. But here we come to a complicating wrinkle of the new law.

Attribution rules waived on termination

With respect to the third complete termination test the law, in effect, says, "If certain conditions are satisfied, then with respect to that one test, the family ownership rule will be waived." If these conditions are met, the wife will not be treated as if she owns her husband's stock. And if she is not treated as if she owns her husband's stock, her interest has been completely terminated.

What are those conditions? There is a set of conditions dealing with situations where there have been prior transfers of stock between the stockholders. We do not have such a set of facts here, and we are not now concerned with that set of conditions.

One condition is that the stockholder whose interest is being redeemed shall not, for ten years after the redemption, acquire an interest in the corporation, either as a director, officer or employee, or as a stockholder (unless stock is acquired by inheritance). This appears to be the only condition we need concern ourselves with. It seems that if this wife does not, for ten years after the redemption, become a stockholder or an officer, director, or employee of the corporation, the condition would be satisfied. The conditions being satisfied, the family ownership rule is waived with respect to the complete termination test. With that rule waived, the wife's interest in the corporation is regarded as completely terminated, and a redemption of her stock would be treated like a sale, entitled to capital-gains treatment.

If, unwittingly, seven or eight years later, she became a director, officer, or employee, the condition would be violated, and the family ownership rule must be used in applying this test. In that event, she owns her husband's stock—or is treated as if she did—her interest did not terminate—and the redemption results in a dividend. (The law provides a method for holding the year open for this purpose until it is clear that future conditions have been met.)

Redeeming wife's shares

Suppose a sole shareholder, owning 100 shares worth $6 per share and with a basis of $1 per share [i.e., the shareholder described in the box on page 323. *Ed.*], studied this result in the husband-wife situation, and suggested the following: "I will give 50 shares to my wife and keep 50. Later the corporation will redeem *her* 50 shares. If the family ownership rule is waived in applying the complete termination test, will this be regarded as a termination of my wife's interest, so that the $300 which she gets—and I would just as soon she get it as myself—will be taxed as long-term capital gain?"

The answer is no. The law, in effect, says, "In applying the complete termination test, the family ownership rule will not be waived if the stockholder, whose stock is being redeemed, *acquired* that stock within the prior ten years"—whether by sale or gift does not matter—"from a person to whom the stockholder bears one of these relationships."

As a result, the wife who owns stock in the corporation which she acquired from her husband within ten years before the redemption will be treated as if she owns her husband's shares, and she will be so treated for purposes of the complete termination test.

The same sole shareholder might ask, "If I give 50 shares to my wife, but *my* 50 shares, not hers, are redeemed, will the tax result be favorable?" The answer is that the law provides for a similar result with respect to the person who *gives* the stock. That is, the law provides that if the stockholder whose stock is being redeemed gave stock away within the prior ten years to a person to whom he bears one of these relationships, then in applying the complete termination test, he has violated one of the conditions for waiving the family ownership rule. Therefore he will be regarded as owning his wife's stock; there is no termination of his interest; none of the tests has been met; and he pays a dividend tax.

In other words, speaking generally, the law is here concerned with the stockholder who desires to redeem some of his stock at a capital gain, and who tries to fit within the complete termination test by first giving some stock to a related person, hoping then that the redemption either of all his stock or all of the stock of the related person will be treated as a sale, with one of them left holding the remaining stock. These conditions, which bar the waiver of the family ownership rule, are designed to prevent that result.

One qualification is to be added. The law provides that these conditions have not been violated if such stock transfers did not have income-tax avoidance as a principal purpose. Usually we would not care to rely on disproving such a purpose.

Redemption from an estate

Suppose now we have a corporation owned by a husband and wife, each having put in $50 for 50 shares, 100 shares outstanding. The corporation has accumulated profits of $500. Each share is worth $6; tax basis, $1 per share.

The husband dies. The stockholders are the wife and the husband's estate, which could use $300 cash. If

SECTION 302'S THREE TESTS: A SIMPLE EXAMPLE

OUR CONCERN is the tax problems in the case of a closely held corporation when a principal stockholder dies and there is a buy-sell agreement. The term buy-sell agreement is used here to cover an agreement obligating the corporation to buy and the stockholder to sell, not agreements between stockholders. Here is a simple example showing how Section 302 controls such a situation.

Suppose five years ago, in 1951, a man formed a corporation. He put in $100. He took 100 shares. His cost or tax basis for the 100 shares is $100, or $1 per share. The corporation operates successfully, accumulating earnings and profits at the rate of $100 per year. Today after 5 years the corporation has an earned surplus of $500 and capital of $100. His 100 shares have a value of $600, and each share is worth $6.

Our taxpayer today wants $300 cash. If the corporation distributes $300 as a dividend, it is taxable to him as ordinary income at ordinary rates. If he is in a 50% bracket, he pays a tax of $150 and keeps $150; if he is in a higher bracket, he keeps even less.

Suppose instead he sells 50 of his 100 shares to an outside party for $300. He has a gain, $300 received less $50 tax basis, or $250 of long-term capital gain. The maximum effective tax rate would be 25%, or $62.50 tax, as contrasted with much greater tax on a dividend of $300.

However our taxpayer does not want to sell shares to an outsider. He then asks this question: "Why can I not sell the 50 shares to my corporation, take $300 from my corporation on the redemption, and get capital-gains treatment as on a sale?"

Would that redemption be treated like a sale, or like a dividend? For the answer, we must look to Section 302 of the new Code. It provides that a redemption will be treated like a sale, if it meets one of several tests. (For our purposes, we will be concerned with the three basic tests.)

Test one: The redemption will be treated like a sale if it is not essentially equivalent to a dividend. Our stockholder turns in 50 shares and takes $300. This is not essentially different from a dividend. He keeps 50 shares instead of 100, but the 50 remaining shares represent complete ownership of the corporation. He does not meet this test.

Test two: The redemption will be treated like a sale if it is a substantially disproportionate redemption, that is, if his proportionate interest in the corporation is reduced in a specific way set forth in the statute. Our stockholder's proportionate interest is not reduced; he begins and ends a 100% stockholder. He cannot meet that test.

Test three: The redemption will be treated like a sale if his interest is completely terminated. His interest is not terminated. He continues to be a stockholder. He cannot meet the third test.

He meets no one of the three tests. Therefore, the redemption is a dividend. He pays a tax on $300 at ordinary rates.

Suppose later he sells one of his remaining 50 shares for $6. His gain would not, as you might think, be $5 ($6 received less original basis of $1). When the redemption of the 50 shares is treated like a dividend, his tax basis of $50 for those shares is not lost, but it is distributed among his other shares. The 50 shares he keeps get a basis of $100 or $2 per share. If he then sells one share for $6, his gain is $4.

That is an elementary illustration of the new Section 302 and its three tests as applied to a one-man corporation where a capital gain redemption is difficult to achieve. The danger in any close corporation is that the constructive stock ownership rules applied to the family and other relationships of stockholders will cause it to be regarded, in effect, as no more than a one or two man corporation, where the tax results are likely to be unfavorable under these three tests.

the estate sold its 50 shares to an outside party for $300, there would probably be little or no tax. The answer might depend in part upon valuation. Assume at death the value of the 50 shares was $300 (pass over the optional valuation date), and assume the estate takes the stock at a tax basis equal to that value. If it sells at $6 per share: no gain; no tax.

However, this is a closely-held corporation. Purchasers may not be available, and the stockholders may not wish to sell to outsiders. They prefer the estate to sell to the corporation. Suppose the corporation redeemed the estate's 50 shares for $300. Question: Would that redemption be treated like a sale, in which case there is *no tax*, or would it be treated like a dividend, resulting in tax at ordinary rates?

We must look to Section 302's three tests and to the new Section 318 constructive stock ownership rules. In addition to the family ownership rule, there are rules which apply to various other kinds of relationships. One of those relationships is the estate–beneficiary relationship. The law provides that an estate will be treated as if it owns *all* of the stock owned by *each* of its beneficiaries.

Assume the husband's will names the wife as sole beneficiary. Under this rule the estate is treated *as if* it owned the wife's 50 shares as well as its own 50 shares. Before the redemption the estate is therefore regarded as owning all of the shares. After the redemption the estate no longer holds its 50 shares, but it is still considered to own the wife's shares since she is an estate beneficiary. So the estate is treated as if it is *always* the owner of *all* of the stock of the corporation.

Let us turn now to the three tests of Section 302.

Test one: The redemption will be treated like a sale if it is not essentially equivalent to a dividend. It appears to be equivalent to a dividend if the estate is to be regarded as the sole stockholder throughout, and the test is not met.

Test two: The redemption will be treated like a sale if it is a substantially disproportionate redemption which substantially reduces, as specified, the proportionate interest of the stockholder. The estate's interest is never reduced if it is treated as always a 100% stockholder, and this test is not met.

Test three: The redemption will be treated like a sale if it completely terminates the stockholder's interest. The estate's interest does not terminate if it is considered to own the wife's shares.

In applying the complete termination test we found that if certain conditions are satisfied, then the family ownership rule will be waived with respect to that test. But relaxation of the stock ownership rules applies *only* with respect to family ownership, that is, constructive ownership between family members, and only with respect to the complete termination test. There is no waiver at any time of the other forms of constructive stock ownership, such as that between estate and beneficiary, so the estate must always be treated as if it owns the wife's 50 shares. Therefore, the estate cannot meet the complete termination test.

Hence we find in this case of wife and husband's estate that if the corporation redeems the shares held by the husband's estate, the estate must pay a tax at ordinary rates on the $300 which is treated as a dividend. (I pass over the special redemption for death taxes provision in Section 303 which often will be unavailable or only partially available and will not provide the desired solution.)

Assume the redemption occurred, it was so treated, and tax paid. The wife remains with 50 shares in a corporation worth $300, each share being worth $6. Suppose an employee of the business now desires to buy stock, and the wife sells one share for $6. Does she realize a gain? Probably not. Her original cost was $1 per share and if that is her basis, she has a gain. But remember the estate had a basis of $300 which was never taken account of, and for which it received no benefit when the redemption of its shares was treated like a dividend. Is that basis lost? The tax law has never contained a clear answer to the question, and there has always been speculation on "the case of the disappearing basis."

The new Treasury Regulations contain examples indicating that in this situation the tax basis shall be transferred to the other shareholder. If that is done, the wife acquires an additional basis of $300, giving her a total basis of $350, or $7 per share. With that basis if she sells one share for $6, she has a long-term capital loss of $1.

The situation when a son enters the picture

Now, suppose the plot thickens. The husband and wife have a son. Again the husband and wife originally formed the corporation, each putting in $50 and taking 50 shares, and the company has a $500 surplus. Their son desires to come into the business, and the wife gives him her 50 shares. H (husband) and S (son) are now the stockholders.

The husband dies. His estate holds 50 shares, and its tax basis becomes $6 per share. At that point if the corporation redeems the estate's stock, will the redemption be treated like a dividend, taxable at ordinary rates, or will it be treated like a sale, resulting in no tax? Again we must turn to the three tests of Section 302 and to the constructive stock ownership rules of Section 318. And again we must ask, who are the beneficiaries of H's estate?

Suppose H left a very simple will which says: "Everything to my wife." The estate is considered to own the stock owned by the wife, the beneficiary. She actually owns no shares. But she is the mother of S, the son, and she is to be regarded as owning his 50 shares. Hence the estate is treated as if it owned the widow's shares; the widow is treated as if she owned

the son's shares; consequently the estate is treated as if it owned the son's shares. Thus there may be two, three or more jumps—a series—applying these stock ownership rules.

We begin, therefore, with an estate treated as if it owned 100 shares, its 50 and the son's 50. On a redemption it turns in its 50, but it is still considered to own the son's 50 shares. Consequently under these stock attribution rules the estate is treated as if it owns, before and after the redemption, *all* of the corporate stock. With that background, we turn to Section 302 and its three tests.

Test one: The redemption will be treated like a sale if it is not essentially equivalent to a dividend. It appears to be equivalent to a dividend under these ownership rules if the estate is always regarded as a sole stockholder, and the test is not met.

Test two: The redemption will be treated like a sale if it is substantially disproportionate and reduces in a specified way the estate's proportionate interest in the corporation. Under these rules there is no reduction at all in the proportionate interest of the estate which is treated always as a 100% shareholder, and this test is not met.

Test three: The redemption will be treated like a sale if it completely terminates the stockholder's interest. The estate's interest does not terminate if it is treated as the owner of the son's shares. But you will recall that in applying the complete termination test, the family ownership rule will be waived if certain conditions are satisfied.

It might be concluded, if traced in detail which I will not do, that the conditions are here satisfied. The estate will not acquire stock or be a director, officer or employee in the next ten years; and let us assume that the other conditions with respect to previous stock transfers are satisfied. The family ownership rule is waived; the wife is not treated as if she owned the son's shares; the estate will not, therefore, be treated as if *it* owned the son's shares. Thus if these conditions are met the complete termination test might be satisfied because if the estate is *not* considered to own the son's shares, all of its interest will terminate; and the redemption can receive capital gain treatment.

A time bomb set to go off at death

Now we come to the real trouble—the involuntary operation of a buy-sell agreement that forces ordinary income. This is what we have been leading up to.

We have assumed a will giving everything to the wife. Suppose the will says: "Half to my wife, half to my son." Would the result change? For the answer let us look again at the complete termination test and the stock attribution rules. The son, as well as the wife, is now an estate beneficiary. The estate must be treated as if it owned all of the stock owned by each. Again the estate is treated as if it owned the son's shares. But in this case we get to the son from the estate in *one* step, an estate-beneficiary step. We never have to use the family ownership rule to get from the son to the estate because as a beneficiary, the estate is treated in one step as owning his shares.

In applying the complete termination test the family ownership rule is waived if certain conditions are satisfied, but *no other* constructive ownership rules are waived. Whatever may be the facts as to these conditions and whether they are satisfied, if the son is a beneficiary the estate must *always* be treated as if it owned his shares. If so, there can be no complete termination of the estate's interest; the third test is not met; the other two tests are not met; and the redemption constitutes a dividend.

Apparently we have this peculiar situation: If the wife is the only beneficiary of the estate, it may be that the estate's stock can be redeemed with capital gain treatment. But if the son is a beneficiary—or one of several beneficiaries—a redemption of the estate's stock is a dividend taxable at ordinary rates. In this and other situations a buy-sell agreement requiring estate stock to be redeemed can act as a bomb which goes off at death. Many closely-held corporations with mandatory buy-sell agreements may be sitting, unaware, on just such a time bomb.

Thus in determining the tax effects of a stock redemption from the estate, we find that we are vitally affected by the provisions of the husband's will. The lesson is: The tax effect of such buy-sell agreements *cannot* be analyzed today without knowing precisely what the wills and trusts of the stockholders do and will provide. This is the kind of pitfall of which to be wary.

Limit on family attribution

Now, let us add one to the cast of characters. Again we begin with husband and wife and the wife gives 50 shares to son, S. They have a daughter who has married son-in-law, L, who is to enter the business. Assume last year H sold 25 of his 50 shares to L. The stockholders are: H, 25 shares; S, the son, 50 shares; L, the son-in-law, 25 shares.

Consider the estate of one of the younger men. An unfortunate event occurs. L is killed in a plane crash. His estate holds 25 shares, worth today $150 which becomes its tax basis. If L's estate sold the shares to an outsider for $150, it would have no taxable gain and no tax. If instead the corporation redeems the 25 shares, is the redemption a sale resulting in no gain, or is it a dividend taxable in full at ordinary rates?

Again, we must look to Section 302's three tests and Section 318's stock ownership rules. The estate actually owns 25 shares. A vital question always is, who is the beneficiary of the estate? Suppose the son-in-law's will

says, "Everything to my wife." The estate is then considered to own the stock owned by L's young widow. She owns no shares. But she is the daughter of H who owns 25 shares. Hence L's estate is treated as if it owned the stock owned by the young widow, the beneficiary; she is treated as if she owned the 25 shares owned by her father, H; the estate must be treated as if it owned H's 25 shares.

Will L's estate be regarded also as the owner of the stock of S, the son? There is no direct stock attribution between brother and sister, so there is no direct link between the widow and the stock of S, her brother. But query: Can L's estate be treated as if it owned the stock held by L's widow; L's widow be treated as if she owned the stock held by her father, H; H be treated as if he owned the 50 shares owned by his son, S; therefore, L's estate be treated as if it owned the 50 share owned by S? No. The law provides that, although there may be a series of these jumps, in any one series the family ownership rule can be used only once although *other* ownership rules may be used more than once. In our series, the family ownership rule was used more than once since the young widow was considered to own her father's stock, which is one application of family ownership, and the father, H, was regarded as owning S's stock, which is another application of family ownership. Since the family stock ownership rule cannot be used twice in one series, S's stock will *not* be attributed in that way to L's estate.

Applying three tests to L's estate

To sum up the status of L's estate: Before the redemption it is regarded as owning its 25 and H's 25 shares, but not S's 50 shares; that is, it is considered to own 50 out of 100 outstanding shares. After the redemption of its 25 shares it is still regarded as owning H's 25 and S's 50. Applying these rules, the redemption of *all* of L's estate stock is treated *as if* a 50% stockholder had *some* stock redeemed and emerged a 33-1/3% stockholder. With that background, turn to the three tests in Section 302 which we have discussed above.

Test one: The redemption will be treated like a sale if the redemption is not essentially equivalent to

SOME METHODS OF ESCAPE FROM THE STOCK ATTRIBUTION RULES

THE SOLUTIONS which may work in any instance depend, of course, upon the particular facts, stock holdings and relationships. In planning a buy-sell agreement for death, the following are points to consider:

An outright bequest paid out *before* redemption of stock held by an estate means that at the time of redemption the recipient of the bequest is not a "beneficiary" of the estate for purposes of stock attribution. The Treasury Regulations so state. This may provide an answer to some problems. Note with care that other persons who are estate beneficiaries may still have attribution relationships to this individual and through them there may be a dangerous link of his stock to the estate.

Similarly if a trust, created by the will, is set up and receives its principal *before* redemption of the estate's stock, then a beneficiary of the trust appears not to be a beneficiary of the estate at the time of the redemption for purposes of constructive stock ownership. This may be a means of providing for a testamentary disposition for such a person, and yet avoiding dangerous stock attribution results which would otherwise occur.

The remainderman of a legal life estate is not an estate beneficiary for purposes of these rules, according to the Treasury Regulations, because he has no direct present interest. It may, therefore, be possible in some cases to make testamentary provision for a person in this way, and yet to avoid attribution of his stock to the estate—again his relationship to estate beneficiaries must be watched.

The beneficiary of a lifetime trust established by the testator does not appear to be a "beneficiary" of the estate—even though the trust may be includible in the estate for Federal estate tax purposes. This may make it possible to cut a person out of the will so that his stock will not be attributed to the estate, and yet to make adequate provision for him by way of a trust of other assets, on which the testator can hold all the strings during life.

Corporate stock can be kept out of a will by putting it into a lifetime trust; all strings can be held during life. The stockholder at the time of redemption under the buy-sell agreement would then seem to be the trust, not the estate, and there would be no direct stock attribution between the trust and the estate beneficiaries. The beneficiary provided for by the trust would be kept out of the will and would not be an estate beneficiary. In this way dangerous relationships can sometimes be avoided.

A safety-valve for the future can be provided, in some cases, by making redemption under a buy-sell agreement contingent upon obtaining favorable opinion from counsel, or upon receiving a Treasury ruling. This will not always be desirable.

These are, of course, rough suggestions and not blueprints. A complete plan requires careful charting of the law applicable to the precise facts.

a dividend. If a 50% stockholder turns in some stock for cash, no other stockholder turns in stock, and the 50% stockholder comes out holding 33-1/3% of the remaining stock—is that essentially equivalent to a dividend? Many people might feel it is not, but the question of equivalence to a dividend is often cloudy. If the answer is doubtful and certainty of capital gain is desired, it is necessary to fit squarely within one of the other more specific tests.

Test two: The redemption will be treated like a sale if it is substantially disproportionate. This test has two requirements which for our purposes can be succinctly stated. Requirement one of test two: After the redemption the stockholder must own less than 50% of the voting power. After the redemption L's estate, considered to own H's stock, is treated as if it is a 33-1/3% stockholder; clearly under these rules it is regarded as owning less than 50% of the voting power.

Requirement two of test two: After the redemption the stockholder shall have a proportionate interest in the corporation which is less than 80% of his proportionate interest before the redemption. L's estate is treated as if it were, before the redemption, a 50% stockholder. To meet this requirement it must emerge from the redemption with less than a 40% interest. It does since we find it emerges being treated as a 33-1/3% stockholder.

Consequently on these facts L's estate would meet both requirements of the substantially disproportionate redemption test, and the redemption of the stock of L's estate would be treated as a sale. So treated, there is no taxable gain, and no tax.

But a less favorable result could occur

A different distribution of stock, however, can lead to less favorable results. For example, suppose L's estate begins again with 25 shares, but H has 50 shares, not 25, and S has 25 shares, not 50. If you do the arithmetic, you will find these rules will make L's estate a 75% stockholder before the redemption (owning its 25 and H's 50 out of 100 outstanding) and a 66-2/3% stockholder after the redemption (owning H's 50 out of 75 outstanding). This fails to meet the substantially disproportionate redemption test because: requirement one is not satisfied since L's estate does not have less than 50% of the voting power; and requirement two is not satisfied since L's estate's proportionate interest after the redemption is not less than 80% of its proportionate interest before the redemption (66-2/3% exceeds 60%, which is 80% of 75%). Only the third test of complete termination would then remain as a possibility, and the conditions for waiving the family ownership rule under the test would have to be studied carefully to appraise the safety of that path to capital gain.

I will not go further into the intricate workings of these sections. The purpose here is not to stress the technical details. This article is not intended to describe completely or probe fully these complicated provisions. The reader is here warned that an actual problem requires painstaking analysis of the law, especially the constructive stock ownership rules whose ramifications have barely been suggested, and the conditions for waiver of the family ownership rule under the complete termination test whcih are extremely involved. The goal here is to give a general idea of how these sections operate and, most important, to illustrate a few typical problems in order to warn of the snares that may await unsuspecting taxpayers even in simple types of corporate situations.

Revenue Ruling 56-103 reveals problem

The pitfalls are put in sharp focus by a recent published tax ruling, Rev. Rul. 56-103 (1956 Int. Rev. Bull. No. 12 p. 7). It involved in one relatively simple case many of the basic elements we have been discussing: a buy-sell agreement; stock redemption from an estate; and stock attribution between the estate and a beneficiary who was himself a stockholder. The estate owned 27%; the decedent's son owned 48%; and unrelated corporate employees owned 25% of the corporate stock. The decedent's son was the sole beneficiary of the estate.

The buy-sell agreement provided that the corporation would buy from the estate as many shares as could be purchased for a specified amount of money, the purchase price per share being set at book value at death. That amount of money, at death, would have redeemed a 13% interest in the corporation. It was desired, however, that the corporation should redeem all of the estate's stock. Accordingly, the corporation redeemed all of the estate's 27% stock interest at a price per share equal to book value at death. The question was whether the estate was entitled to capital-gains treatment.

The ruling disposed brusquely of Tests Two and Three as follows:

"In the instant case, the estate of B, for the purposes of Section 302, is considered to own all of the stock owned by the sole beneficiary of the estate. Therefore, the estate owned 75 per cent (27 per cent plus 48 per cent) of the shares of the corporation's stock. Hence, such a redemption did not qualify as a termination of a shareholder's interest or as a substantially disproportionate redemption under Section 302 (b) (2) and (3) of the Code."

The ruling does not take the trouble to spell out the arithmetic there involved. With estate-beneficiary stock attribution, this redemption is just as if a 75%

[*Editors' note: Mr. Hoffman recently discussed this subject at the annual Estate Planners Forum held by Solomon Huber Associates, in New York. Because of the importance of this hazard to taxpayers, we invited Mr. Hoffman to expand his discussion; the accompanying article is the result.*]

stockholder had emerged a 65.8% stockholder (i.e. after the redemption the estate constructively holds 48 out of 73 shares then outstanding). This fails to meet the complete termination test. Nor does it meet the substantially-disproportionate-redemption test since neither requirement of that test is satisfied. (It may be noted that these two tests would not have been satisfied even if the corporation had redeemed no more than the precise number of shares required under the contract.)

The most significant aspect of the ruling is the holding that Test One of Section 302 has not been met. The ruling states:

"A redemption of stock which does not as a practical matter change the essential relationship between the stockholders and the corporation is generally considered equivalent to a dividend. See *John T. Roberts et al.* v. *Commissioner,* 203 Fed. (2d) 304.

"As the relative stock interest of the principal shareholder was not materially changed by the redemption, the distribution to him is equivalent to a dividend. *J. Natwick* v. *Commissioner,* 36 B.T.A. 866; *W. & K. Holding Co.* v. *Commissioner,* 38 B.T.A. 830. The fact that the redemption is pursuant to a contract between the corporation and the decedent does not appear to be significant for this purpose."

The ruling flashes several warning signals. First, it sets forth the position of the Revenue Service to the effect that if a 75% stockholder turns in some of his stock and emerges holding a 65% interest, the redemption will be regarded as equivalent to a dividend taxable at ordinary rates to the extent of corporate earnings and profits. Question: at what point will the interest of such a shareholder be regarded as having been "materially changed by the redemption?" Must he retain less than a 50% stock interest and give up voting control before the Service will acknowledge that the redemption does "as a practical matter change the essential relationship between the stockholders and the corporation?"

Secondly, the ruling makes clear that this interpretation of "essential equivalence to a dividend" under Test One will not be relaxed because the percentages of interest in the corporation result from stock attribution rules and not from real ownership. Thus this ruling holds that if a stockholder, who owns actually 25% but constructively 75% of the stock, turns in *all* of his stock and comes out *actually* owning *no* shares but *constructively* owning 65% of the shares, the redemption will be treated as equivalent to a dividend.

Finally, the ruling indicates the Service's position with respect to buy-sell agreements to be that such an agreement "does not appear to be significant for this purpose." Some tax thinkers have urged that the existence of a buy-sell agreement might supply a "business purpose" which would provide justification for a redemption sufficient to bar dividend treatment. This ruling dispels any hope in the ordinary case for administrative recognition of such an exception.

In sum, therefore, the ruling provides a striking illustration of the hazards which have been discussed. It indicates the tax havoc that can result to an estate from the total combination of a mandatory buy-sell agreement, the new stock attribution rules, and the new Section 302 tests, together with a tough Revenue Service position on redemptions regarded as equivalent to a dividend. The ruling paints, with a broad brush in simple colors, the picture of an estate paying a dividend tax under the 1954 Code on a redemption of *all* of its stockholdings.

Conclusion

This should be very clear: A buy-sell agreement which has been drafted without painstaking study of these new provisions should be examined again, immediately and carefully. A buy-sell agreement which was drafted before 1954 and was satisfactory under the old Code should be immediately and thoroughly reviewed.

Revision of the agreement involves studying existing family and other relationships, and projecting into the future to consider prospective estate, trust and beneficiary relationships. To accomplish the desired objectives may involve recasting the buy-sell agreement, redrafting wills to add or delete certain provisions, establishing new lifetime trusts, changing certain business relationships, and so forth (see Box on Methods of Escape. Ed.). The task frequently entails a thorough overhauling of the stockholders' estate plans. Properly done it may lead the clients safely around or through these sections into the Promised Land of Capital Gain. But to keep or make a buy-sell agreement today without doing that job is to challenge fate.

The moral of this tale is: Beware! ☆

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Are we so sure a non-grantor trustee is taxable in a support trust?

by WILLIAM S. MOORHEAD, JR.

Many authorities apparently think that the 1954 Code taxes a trustee on income over which he has the power to distribute for the support of his dependents. This author, on the basis of analysis of the Code and court decisions, offers the suggestion that this may not be so — that the trustee is not so taxable. He outlines his thinking here

IS AN INDIVIDUAL TRUSTEE, who is not the grantor of the trust, subject to income tax where, as trustee, he exercises a power to distribute income to or for the benefit of his legal dependents?

This problem can best be presented by a hypothetical case which is not uncommon in family estate planning:

Grandfather establishes a trust naming his son, Father, as trustee and Father's wife and minor children as beneficiaries. As trustee, Father is given the power to accumulate income or sprinkle the income among his wife and minor children or to apply the income for their support.

Is Father subject to any income tax under Section 678 of the Internal Revenue Code of 1954?

Most writers who have considered the problem have concluded that Father is taxable under Section 678 (c) to the extent that the income is used for the support of wife and minor children.[1] None of the writers has set forth the technical construction of the statute by which they reached this conclusion.

The conclusion cannot be reached by reference to subsection (c) alone. Subsections (b), (c), and (d) of Section 678 do not impose any tax. They are merely posed by subsection (a). Therefore, it is necessary first to find that a tax has been imposed by subsection (a) before the limitation stated in subsection (c) can be considered. This legislative form of the general rule imposing the tax with other subsections creating exceptions or limitations is found also in Sections 673, 674, 676, and 677 of Subpart E.

The structure of the section appears to have been disregarded by some of the writers. In our hypothetical case, if Father were named co-trustee with a trust company, there could be no tax imposed under subsection (a), because Father never would have had "a power exercisable *solely* by himself." (Emphasis supplied) Because no tax is imposed by subsection (a) in that situation, the limitation created by subsection (c) need not be considered. Despite this, several of the writers have concluded that Father as a co-trustee would be taxable.[2]

In our hypothetical case where Father is the sole trustee, in order to find a tax imposed by subsection (a), it would be necessary to add wording to Section 678 (a) (1) by implication so that Section 678 (a) (1) would read:

"(a) General Rule. — A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

"(1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or" *for his benefit or for the support of his legal dependents, or . . .*

If Section 678 (a) (1) is read as impliedly containing this emphasized added phrase, Father would be taxable because he has the power to apply all of the income for the support of his wife and minor children. But even in this case, when the limitation contained in Section 678 (c) is read with Section 678 (a) with this additional wording, it becomes clear that where the power of a non-grantor (Father) consists solely of a power to vest income in his legal dependents, the non-grantor would be taxable only to the extent that the income is so applied.

What does "himself" mean

The primary argument for the foregoing broad construction of the word "himself" in Section 678 (a) is that it would not be reasonable to restrict the word

"himself" to its strictly literal meaning. Some authority for this position may be found in *Ralph W. Conant,* 7 TC 453 (1946). In that case the grantor created a trust and empowered his wife to direct the trustee as to the distribution of income. The trustee was also empowered to pay a debt of the grantor which was secured by a pledge of some of the trust assets. The Tax Court (with one dissent and two concurring opinions) held that the wife was taxable on the income except to the extent that it was used to discharge the grantor's debt and that the grantor was taxable to that extent.[3] It is clear that the grantor in the *Conant* case intended that the income of the trust be used for his own personal benefit.

The principle of the *Conant* case has never to my knowledge been extended to the situation where grantor established a trust and empowered the trustee to discharge a debt of a non-grantor. However, it is not difficult to imagine a case where such an extension would be made. In our hypothetical case, if Grandfather had empowered Father as trustee to pay off the bank which holds the mortgage on Father's house, there would be little doubt that Father would be taxable at least to the extent that the income was so used. It is clear that Grandfather intended to benefit Father and empower Father to vest income in himself or for his benefit. The language of Section 678 (a) could be construed so as to impose a tax on Father in this situation because Grandfather intended Father to be the primary beneficiary of the income of the trust.

Where the recipient of the income is not the bank which holds the mortgage on Father's house, but rather the grandchildren of the grantor, the intention of the grantor and the tax consequences are not so clear. It is submitted that this situation should be treated differently, first because the incidental benefit to Father from the discharge of the vague unliquidated obligation to support his children is much less clear than the benefit which would flow from the discharge of a fixed legal debt, and second, because it is quite likely that in establishing the trust Grandfather intended to benefit primarily his grandchildren rather than Father.

What was Congressional intent?

As stated above, in order to reach the conclusion that Father is taxable, where his only power is to vest income in his children, the word "himself" in Section 678 (a) must be construed very broadly to include "for his benefit or for the support of his legal dependents." Did Congress intend this broad construction?

If the word "himself" in Section 678 (a) be so broadly construed, a tax will be imposed on a non-grantor in a situation where none had been imposed under the 1939 Code. There is no indication that the Congress intended such a change in enacting Section 678. In fact, the Congress referred to the section as containing a "liberalizing provision" and not one which would impose a tax where no tax would have been imposed under the 1939 Code: see House Committee Report, p. 217, 83rd Congress, Second Session, p. 4357.

Under the 1939 Code, the cases imposed a tax on a non-grantor only where the non-grantor had power to vest either corpus or income in himself *personally*. In *Mallinckrodt v. Nunan,* 146 F.2d 1 (CA-8, 1945) affirming 2 TC 1128; *Bunting v. Commissioner,* 164 F.2d 443 (CA-6, 1947); *cert. den.* 333 U.S. 856; *Leon Falk, Jr.* 15 TC 49, *aff'd* 189 F.2d 806; *cert. den.* 342 U.S. 861 (1950); and *Alfred Cowles,* 6 TC 14 (1946), the Commissioner argued successfully that the power of the non-grantor to vest corpus or income in himself *personally* made the non-grantor, in substance, the owner of the trust and hence taxable.

There were cases in which the non-grantor of a trust received a benefit from the distribution of the income of the trust and yet was held to be not taxable. In *Stern v. Commissioner,* 137 F.2d 43, 45 (CA-2, 1943), where the brothers of a woman named co-respondent in a divorce action established a trust to discharge husband's duty to pay alimony, it was held that even though the trust discharged the husband's legal obligations, he was not taxable because he furnished no part of the capital of the trust. See also *Allison L. S. Stern,* 40 BTA 757; *acq.* and *non-acq.* 1940-1 C.B. 4 and 8.

In *Frank E. Joseph,* 5 TC 1049 (1945) (acq. 1946-1 C.B. 3), the wife's exercise of a general power of appointment over a trust in favor of husband was invalidated by the birth of a son. After wife's death, husband entered into an agreement with trust company transferring all of wife's appointive property to trust company to pay the income to him for the sup-

[1] Casner, "The Internal Revenue Code of 1954; Estate Planning," 68 *Harvard L. Rev.* 433, 460-1 (1955); Smith, "Clifford" Trusts," *Digest of Tax Articles,* December 1954, p. 16; Kamin, Surrey, and Warren, "The Internal Revenue Code of 1954: Trusts, Estates and Beneficiaries," 54 *Col. L. Rev.* 1237, 1263-4 (1954); Winton, "Trusts for Support of Dependents," 94 *Trusts and Estates* 196, 239 (March 1955); Mannheimer, Wheeler and Friedman, "How to use Sprinkling Trusts," 33 *Taxes* 532, 545-6 (July, 1955); Stern, "A Tax Trap for the Family Trustee," 33 *Taxes* 594, 594-5 (Aug. 1955); Nance, "Taxation of Trust Income to Grantors and Others as Substantial Owners of the Property," 33 *Taxes* 899, 908-9 (Dec. 1955).

[2] Casner, *op. cit. supra,* pp. 460-1; Kamin, Surrey, and Warren, *op. cit. supra,* pp. 1263-4; Mannheimer, Wheeler and Friedman, *op. cit. supra,* pp. 545-6, Winton, *op. cit. supra,* p. 240, and Nance, *op. cit. supra,* reaches the opposite conclusion.

[3] The same result could have been reached under Section 39.162-1 (f) of the Regulations under the 1939 Code. This Regulation was not cited in the *Conant* case. It does not appear to have been enacted in the 1954 Code.

Reg. Section 39.162-1 (f) provided: "Any income of an estate or trust for its taxable year which during that year may be used, pursuant to the terms of the will or trust instrument, in the discharge or satisfaction, in whole or in part, of a legal obligation of any person is, to the extent so used, taxable to such person as though directly distributed to him as a beneficiary, except in cases to which section 22 (k) or section 171 applies. See §§ 39.167-1, 39.171-1, and 39.171-2."

port of son. It was held that husband was liable for income tax only upon such portion of the income as accrued upon the portion of the principal of the trust contributed by him, and not on the income from the principal to which the son would have been entitled.

Allen v. Nunnally, 180 F.2d 318 (CA-5, 1950), is quite similar to our hypothetical case. Grandfather established a trust with a trust company for the benefit of his grandchildren but provided that son would have broad powers to amend the trust including changing the trustee or the beneficiaries. The court held that the son held this power in a fiduciary capacity and therefore could not require the income to be paid to him for his personal use and benefit. Hence the court held that the son was not taxable even though the income could be used for the support of his dependents and had, in fact, been used for that purpose in prior years.

A possibly contrary result was reached in *Stix v. Commissioner,* 152 F.2d 562 (CA-2, 1945). In this case mother created two trusts, naming her two sons A and B as trustees. One trust was for the benefit of A as the "Primary Beneficiary;" but provided that the trustees in their discretion could pay the income to the children of A. The other trust was for the benefit of B as the "Primary Beneficiary," but provided that the income could be paid to the children of B. During the years in question, all of the income was distributed to the minor children of A and B. Nevertheless, A and B were held taxable. It would seem that this case is distinguishable from our hypothetical case because the reciprocal nature of the two trusts in effect gave A and B the practical power to obtain the income from the trusts. Furthermore, the terms of the trust clearly show that A and B and not their children were the primary beneficiaries of the trust.

HERE IS WHAT APPLICABLE PORTION OF THE LAW SAYS

THE QUESTION of taxability of the trustee being discussed in this article relates particularly to Section 678 of the 1954 Code. This is what it says:

SEC. 678: PERSON OTHER THAN GRANTOR AS SUBSTANTIAL OWNER.

(a) General Rule.—A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

(1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or to vest the corpus or the income therefrom in himself, or

(2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of Sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

* * *

(c) Obligations of Support.—Subsection (a) shall not apply to a power which enables such person, in the capacity of trustee or co-trustee, merely to apply the income of the trust to the support or maintenance of a person whom the holder of the power is obligated to support or maintain except to the extent that such income is so applied. . . .

What does Section 678(c) really mean?

In view of the status of the law at the time Section 678 of the 1954 Code was enacted, and in view of the fact that Congress believed that Section 678 (c) was a liberalizing provision, it would seem that the non-grantor (Father in our hypothetical case) should not be taxable on any part of the income of the trust. This result is indicated by the legislative history, and the statute can readily be construed to reach this result.

This conclusion can be reached if Section 678 (c) is read so as to apply only to Section 678 (a) (2). At the same time, the word "himself" in Section 678 (a) must be strictly construed to mean himself personally, although it is possible that the word "himself" might be expanded to include the discharge of a legal debt of the type considered in the *Conant* case.

Under this construction, Section 678 (a) (1) is not affected by Section 678 (c) because if a non-grantor has the power to vest corpus or income in himself personally, he is, in substance, the owner of the trust and is taxable on all the income therefrom.

Section 678 (a) (2) concerns a non-grantor who is substantially the owner of the trust and who releases some of his powers. He is in effect creating a new trust and the tax question is whether or not he has divested himself of ownership. Section 678 (a) (2) incorporates Sections 671 through 677 (substantially the old *Clifford* Regulations) by reference. If he releases these powers for a short period of time or retains certain powers, he is taxed as a grantor and the substantial owner of the trust.

Effect of Mallinckrodt Regulations

This is what the *Mallinckrodt* Regulations did under the 1939 Code Regulation. Section 39.22 (a)-22, provided:

"*Trust income taxable to person other than grantor.* Where a person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, the income therefrom shall be included in

computing the net income of such person. Even though such a power has been partially released or otherwise modified so that the person holding it can no longer vest the corpus or the income of the trust in himself, the income shall continue to be taxable to such person, if after such release or modification, he has retained such control of the trust as would, within the principles of Section 39.22 (a)-21, subject a grantor of such a trust to tax on the income thereof. This section shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor is otherwise taxable under Section 39.22 (a)-21. See also Section 39.166-1. [Reg. 118, Section 39.22 (a)-22.]"

It is submitted that in our hypothetical case Father, who never had any power to vest income in himself and who therefore never released "such a power," would not have been subject to any taxation under the *Mallinckrodt* Regulations of the 1939 Code.

The problems arising when Father releases a power to vest income or corpus in himself explain the apparent conflict between the use of the word "solely" in Section 678 (a) and the word "co-trustee" in Section 678 (c). For example, if Father had had, and had released, a *sole* power to vest income in himself but retained a power as *co-trustee* to apply income for the support of his legal dependents, he would be taxable under Section 678 (a) (2), limited, however, by Section 678 (c), to the amount of income so applied. Under this construction the apparent conflict between the use of the words "solely by himself" in subsection (a) (1) and the word "co-trustee" in subsection (c) can be reconciled.

Where did Mallinckrodt apply?

There is a possible interpretation of the Mallinckrodt Regulations which would make them provide for heavier taxation of a non-grantor than a grantor. I mention this argument only to present a complete review of this problem; it depends on an interpretation of Regulations which is supported by no cases (see above). Furthermore, it is not usual to strain to extend the Regulations; if the Commissioner intended them to apply further, he could have said so.

Under the 1939 Code, if Father had had the power to vest income in himself and then released it retaining only the right to pay income in specified shares to his legal dependents, he would not have been taxable at all because such a power alone did not render a grantor taxable under the *Clifford* Regulations (See Regulations, Section 39.22 (a)-21 (d) (4) (dd)) even though a *grantor* would have been taxable to the extent the income was used for the support of his dependents under Section 167 (c) of the 1939 Code.

Now, if the *Mallinckrodt* Regulations could be interpreted to impose a tax on the non-grantor in the situation where he retained only the power to pay income in specified shares to his legal dependents, then he would be subject to taxation on all the income whether used for their support or not because the *Mallinckrodt* Regulations incorporate the *Clifford* Regulations but do not incorporate the limitation found in Section 167 (c) of the 1939 Code.

If Congress believed that this result was possible under the 1939 Code, then the non-grantor was subject to greater taxations than the grantor and the addition of Section 678 (c) could really be considered a "liberalizing provision" as stated in the House and Senate Reports: See Sen. Rpts. 83rd Congress, Second Session, p. 4357 and p. 5013.

None of the authors who have commented on this section have been able to explain what Congress meant by referring to Section 678 (c) as a "liberalizing provision" except to conclude that this was a mistake on the part of Congress. The construction of Section 678 suggested herein can explain what Congress meant by referring to Section 678 (c) as a liberalizing provision. In addition, the suggested construction reconciles the apparent conflict between the use of the word "solely" in 678 (a) (1) and the use of the word "co-trustee" in 678 (c). Finally, the suggested construction recognizes the fact that in Section 678 only subsection (a) imposes a tax and that subsection (c) does no more than limit the imposition of the tax.

Estate planners must await the promulgation of Regulations under Section 678. It is to be hoped that the Regulations will be drafted so that the use of an individual trustee can be continued. It is more important, however, that the problem be recognized and the construction of Section 678 be clarified so that estate plans can be made with some degree of certainty as to the tax consequences. ☆

TAX CONSEQUENCES OF

Corporate organization and distributions

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Buying corporation with large earned surplus; two types of transactions

by BAXTER K. RICHARDSON

WHEN THOSE IN CONTROL of a successful closed corporation desire to sell out their stock, the prospective buyers often are unable to pay a price commensurate with the existing earned surplus. The buyers usually do not wish to finance the purchase by declaration of dividends to be applied to the purchase price, since the buyers will pay ordinary income tax on the dividends.

The problem therefore frequently arises as to how to provide an adequate purchase price (at capital gain rates) to the sellers, and at the same time minimize the buyers' outlay. The attractive solution is in part to employ corporate funds to pay the sellers. Therefore, where substantial sums are involved, the Treasury is likely to contend that either the seller or the buyer has received a taxable dividend in connection with the transaction.

The cases involving this situation fall into two factual patterns. In some cases, which we shall call Type A cases, the buyer initially acquires a small bloc of shares, without otherwise expressly obligating himself to anyone. The corporation thereafter redeems all the stock of the seller, who reports capital gain upon the entire transaction.[1]

In other cases, herein called Type B cases, the buyer personally agrees to purchase all the seller's stock. Thereafter, in one way or another, corporate funds are used to complete the payments to the seller. See *Woodworth v. Commissioner,* 218 F.2d 719 (CA-6, 1955) (buyer borrowed from corporation to complete purchase, pledging newly purchased shares, and subsequently surrendered shares in consideration of cancellation of the debt); *Lowenthal v. Commissioner,* 169 F.2d 694 (CCA 7, 1948) (buyer withdrew funds from corporation in exchange for previously purchased stock); *Wall v. United States,* 164 F.2d 462 (CA-4, 1947) (payment by corporation of installment of purchase price in consideration of surrender of stock by buyer).

In Type A cases, the Treasury has variously contended that the redemption by the corporation of the seller's stock constituted a dividend to the seller *(Zenz v. Quinlivan, supra),* or to the buyer *(Schmitt v. Commissioner, supra, Fox v. Harrison, supra,* and *Estate of Searle, supra).* The courts have refused to hold that the seller received a dividend, despite the steps in the transaction, because his interest in the corporation was being entirely severed. See *Auto Finance Company, supra.* The courts have also declined to find that the buyer received a dividend in connection with the transaction, in the absence of evidence that he personally undertook to buy the seller's stock and thereafter caused the corporation to take over that obligation.

In Type B cases, the Treasury has nearly always been successful in contending that the buyer received a dividend, either when the corporation made payments on his obligation, or when the buyer surrendered newly purchased shares in exchange for funds with which to make the payments.

Obviously, in both Type A and Type B cases, the buyer uses corporate funds to acquire control of the corporation in which he is interested. Indeed, in the Type B case above cited, the buyers contended, without success, that the series of transactions should be regarded as one transaction, in which the corporation in reality purchased the stock of the sellers. And it seems clear that in all the Type B cases, the buyers could have avoided a taxable dividend if the transaction had taken a different form. The court in the *Woodworth* case admitted as much:

"It is true that the syndicate members could have achieved their objective, yet completely avoided the tax liability here imposed, simply by their purchase of the two hundred shares owned by the minority shareholders, followed by Buckeye's redemption of all Mrs. Derby's stock. We can assume that if the transaction had been cast in that form neither petitioners nor Mrs. Derby would have been charged with the receipt of ordinary income. Cf. *Zenz v. Quinlivan,* 6 Cir., 1954, 213 F.2d 914."

The Tax Court has recently followed the rule of the Type A cases in declining to find a dividend where invited by the taxpayer to do so. In *Auto Finance Company* 24 TC No. 47 (1955), aff'd. 229 F.2d 318 (CA-4, 1956) the majority interest in two corporations was held by a third corporation. This corporation, in arranging to divest itself of its interest, preferred to receive dividends, eligible for the 85 per cent credit, instead of capital gains, taxable at 25 per cent. The individual buyers, of course, objected to dividends, so preferred-stock dividends in the amount of the earned surplus of the two subsidiary corporations were issued. The parent corporation sold its common stock to the individual buyers, but its preferred stock was redeemed. The parent corporation claimed the redemption was a dividend to it, no doubt in reliance upon the long line of cases holding that issuance and subsequent redemption of preferred stock according to plan constitutes a taxable dividend. But the Tax Court held that all proceeds received by the parent corporation were capital gain, the essence of the transactions being severance of all its interest in the subsidiaries.

By analogy, it would appear that if the seller is indebted to the corporation, the debt may be cancelled as a part of the transaction, with no dividend to the buyer and with capital gain treatment of the seller's income realized upon the debt cancellation. *Freeland Ham,* TCM 1955-161.

[1] See *Zenz v. Quinlan,* 213 F.2d 914 (CA-6, 1954); *Schmitt v. Commissioner,* 208 F.2d 819 (CA-33, 1954); *Fox v. Harrison,* 145 F.2d 521 (CA-7, 1944); see also *Auto Finance Company,* 24 TC No. 47 (1955) and *Estate of Ira S. Searle,* TCM, Docket Nos. 24804, 24805 (1950).

At present, then, it appears that where outsiders or a minority desire to gain control of a profitable corporation, they may do so by acquiring a small bloc of stock, then having the corporation redeem all the stock remaining in the hands of the former majority group. The old majority group does not receive a dividend, since its interest is being terminated, but nevertheless receives a price commensurate with the corporation's assets. The new majority group pays a price within its reach and obtains a successful corporation without a large earned surplus. A loophole may thus appear to exist. (See Rev. Rul. 55-745, IRB 1955-52). The question may well be asked, however, whether such a transaction would not suggest to a treasury agent that the corporation had unreasonably accumulated surplus.

Where the attribution rules of Section 318 apply, caution must be exercised in planning a Type A transaction to ensure that all the stock of the selling group is redeemed, or that enough is redeemed for the distribution to qualify as disproportionate under Section 302. Of course, this type of transaction will not result in stepped-up basis on the corporate assets, except as provided in Section 334(b). ☆

IRS follows Zenz, gives us more favorable rule on distributions to stockholders

THE IRS HAS DEMONSTRATED a liberal attitude in two recent rulings pertaining to distributions. In *Rev. Rul.* 55-745 (52 IRB 9, Dec. 27, 1955), the Service has agreed to follow the *Zenz* case under Section 302 of the 1954 Code. A previous ruling had adopted the *Zenz* decision under Section 115(g)(1) of the 1939 Code in similar factual situations (taxpayer first sold part of her stock to an outsider and then shortly thereafter sold the remainder of the stock to the corporation for cash and property about equal to the earned surplus). The court had held the redemption was not a dividend since the taxpayer was separated from all interest in the corporation.

The Service has now ruled that this type of transaction qualified as a complete termination under Section 302(b)(3) of the 1954 Code, and hence, not a dividend. It was not, however, a "partial liquidation" under Section 346. Lest we become overly enthusiastic as to the impact of this ruling, we should note that the *Zenz* case and the ruling involved a taxpayer who owned the entire stock before the sale and redemption. If, however, a close member of the taxpayer's family also owned stock under Section 318, then compliance with the complete termination rule of Section 302(b)(3) may be very difficult because of the 10-year backward and forward freezes which greatly limit the application of Section 302.

The second ruling affirms the rather obvious fact that common stock received as a dividend on common stock is not Section 306 stock, even though distributed out of treasury stock. *Rev. Rul.* 55-746 (52 IRB 10, Dec. 27, 1955). At the time of the stock dividend, the corporation had outstanding both preferred and common stock, part of which was held in the treasury. For "bona fide business reasons," the corporation proposes to distribute a common stock dividend to its common stockholders out of common stock in its treasury. Internal Revenue has correctly ruled that it makes no difference whether the common stock is newly issued or is treasury common stock. Hence, the taint of Section 306 stock never rises here.

While it was not expressed, we think it could also have been noted that there was no need for the "bona fide business reasons" for the stock dividend. The absence of tax motive for the distribution and the disposition of Section 306 stock should arise only where the stock otherwise is classified as Section 306 stock. It is also evident that the dividend would not be taxable under Section 305 of the 1954 Code even though preferred stock was also outstanding, and hence, the distribution may have shifted the proportionate interests of the shareholders.

The ruling furnishes a clue as to the Service's policy when it observes that common stock is not Section 306 stock "if the stock that is to be distributed is the same in all respects as the common stock outstanding." Cautious tax men have already anticipated possible imaginative attempts to extend Section 306 to common stock, by making the stock issued as a dividend the same as the old common stock. ☆

New decisions

Notes held really preferred; can't deduct "interest." Taxpayer-corporation took over the assets of a Coca-Cola bottling company in a tax-free exchange. It issued $10,000 in common stock and $254,000 in interest-bearing installment notes. The notes, due in 20 or 30 years, were payable only if the corporation was solvent and were subordinate to all other existing obligations. The Commissioner disallowed the interest deducted by the corporation and the court agrees. The notes were a capital investment in the nature of preferred stock. *Pocatello Coca-Cola Bottling Co.*, DC Idaho, 3/29/56.

Bad debt denied; deemed contribution to capital. Both parties agreed that taxpayer was in the business of operating bus lines. Certain payments, made to a corporation in which he was a stockholder, were deducted as business bad debts. The court instructed the jury that in determining whether the payments were business loans or merely contributions to capital, they should consider whether the payments had all of the usual indicia of loans rather than stock investments and whether the taxpayer was in the business of financing bus lines in addition to operating them and managing his investments. The jury found for the government. *Skalicky*, DC Ind., 2/15/56.

Debt-to-capital ratio of 207 to 1 too thin, though debt and stockholdings not proportionate. Taxpayer was organized with a total capital of $1,000 (which taxpayer conceded was "thin") to purchase, subdivide, and sell a substantial tract of land. To finance the project an additional $57,800 was obtained from the stockholders on interest-bearing unsecured notes, and $149,000 from banks on mortgage loans. The notes for $57,800 were held to represent capital rather than a valid indebtedness, even though the notes were not issued to stockholders in proportion to their stockholdings. The court said that it gave to this circumstance no greater weight than if taxpayer had issued disproportionate amounts of common and preferred. Deductions for "interest" payments on the notes are disallowed. *Colony, Inc.*, 26 TC No. 3.

FHA-insured corporation, after distributing windfall cash, distributes property; no gain to it. Taxpayer was a corporation which built apartments with FHA-insured loans. As agreed prior to construction it distributed the land and buildings pro rata to its four shareholders, who took the property subject to the mortgages. The Commissioner argued that the property had increased in value, and the bargain sale was a gain to the corporation. The FHA loans had exceeded the building costs by over $100,000, and this excess had also been distributed to the shareholders in cash. The court finds that the transfer of the property to the stockholders was not a sale; it was a distribution to them in this capacity as stockholders. It is well settled that a corporation does not realize income on such a distribution of appreciated property (*General Utilities* case). The stockholders received a dividend only to the extent of the available earnings and profits; the excess distribution was to be applied in reduction of the basis of the stock and any remaining balance was taxable as capital gain. [Under the 1954 Code, if an FHA loan in excess of basis is outstanding when a distribution is made, the excess is treated as earnings and profits. *Ed.*] *Pool,* TCM 1956-64.

Corporate black-market profits dividends to stockholder. [*Certiorari denied*] Taxpayer-corporation bought and sold in the black market and transactions were not entered on its books or tax returns; the over-ceiling payments went directly to the stockholders. The corporation argued that understated sales were offset by understated purchases. The Tax Court gave taxpayer-corporation credit for only a few understated purchases which were proved, and held that black-market profits as determined by the Commissioner were dividends to taxpayer stockholders. The Circuit Court affirmed this, as well as the Tax Court's finding of fraud, without discussion. It held that the Tax Court was entitled to judge the credibility of the witnesses. A factor in such credibility is conduct of practices violative of federal price controls. *Chesbro, cert. den.,* 3/26/56.

Commissioner argues redemption not a dividend!! Reason: taxpayer is a corporation. Taxpayer-corporation owned 40.4% of the total stock of Western Oil. Western purchased some shares from taxpayer, leaving the taxpayer holding 20.1% of the outstanding stock. Taxpayer treated the "redemption" as essentially equivalent to a taxable dividend and took a dividend credit of 85%. The court, however, upheld the Commissioner's contention that there was no equivalence to a dividend. The corporation had redeemed some shares of other stockholders. These transactions amounted to a partial liquidation. Further, there was no pro rata distribution to all of Western's then existing shareholders. The gain on partial liquidation was taxable as a long-term capital gain. *Pacific Veg. Oil Corp.,* 26 TC No. 1.

Distribution of cash to old stockholders, prior to their sale, a dividend. Taxpayer owned stock in a corporation holding hotel property. The hotel manager offered to purchase the corporate stock at a stated price after earnings had been distributed to the stockholders. Payment of the earnings by the corporation to taxpayer as stockholder was held to be a taxable dividend and was not a part of the consideration coming from the purchaser of the stock. The court said that while the transaction might have been cast in the form of a simple sale of stock, it was not. The purchaser's offer was for the stock after stockholders had been paid the cash in excess of liabilities. *Gilmore,* 25 TC No. 158.

Redemption of all father's stock from estate a dividend; estate indirectly owns stock of beneficiary son. Decedent owned 27% of the stock of a corporation, 48% was owned by his son, the sole beneficiary of his estate. The corporation was required by contract to buy 13% of the estate stock. It bought all. However, this cannot be treated as a complete redemption; under the Code the estate is considered the owner of the stock owned by the beneficiary, the son, and that stock was not redeemed. Nor can the redemption escape tax as "not essentially equivalent to a dividend." The relative interest of the principal shareholders was not changed. [This tax trap is discussed extensively in the article beginning on page 322 of this issue. *Ed.*] *Rev. Rul.* 56-103.

Preferred received in tax-free merger is "Section 306" stock, but gain on disposition may be capital. Under a plan of merger of two publicly-held corporations, the surviving corporation issued preferred and common stock to the common stockholders of the merged coporations. The exchange is held tax-free; the preferred stock reecived in connection with the merger is "Section 306" stock, because it is preferred received in a tax-free exchange. However, the provisions of Section 306(a)(1) treating the gain on disposition of such stock as ordinary income are held not applicable; there was good business reason for the issuance. The earnings of the merged company were stable but low. The preferred was used to limit the participation of its stockholders in the combined earnings. For this reason the acquisition of the preferred is not in pursuance of a plan of tax avoidance. To avoid ordinary income on sale, the sale, if it occurs, must not be in anticipation of redemptions. *Rev. Rul.* 56-116.

Distribution of subsidiary's stock to a group of parent's stockholders is a tax-free split-up. A corporation engaged in the hardware business owned all the common and 12% of the preferred of a subsidiary appliance corporation. Both corporations had been engaged in the active conduct of their respective businesses for more than five years. In order to effect a separation, the following plan was adopted: first, the subsidiary issued additional shares of its common in exchange for its preferred owned by stockholders other than the parent corporation (after this exchange the parent owned 93% of the preferred); then, the parent distributed the stock of the subsidiary to a dissident group of its stockholders in exchange for their stock in the parent. The latter exchange was held tax-free as a divisive reorganization under Section 355. While the parent acquired control (80% of the voting and non-voting stock) within five years of the split-up, the acquisition of over 80% of the preferred was in a tax-free exchange. Such acquisitions do not come within 5-year ban. *Rev. Rul.* 56-117.

$25,000 surtax exemption and EPT credit denied on tax-motivated split-off. A corporation engaged in the storage of petroleum organized taxpayer, and transferred several oil tanks to it in return for all of its stock. The split-off was motivated by the desire of the parent to minimize renegotiation difficulties by separating the government work, which it continued to handle, from general commercial operations, which were transferred to the subsidiary. The court denied the subsidiary the extra surtax exemption and the $25,000 minimum

excess-profits-tax credit, relying on Section 15(c) of the 1939 Code. This section denies the surtax exemption and the minimum credit to a newly-created corporation taking one property from another corporation controlled by the same interests unless the new corporation shows that securing the exemption or credit was not a major purpose. Taxpayer here failed to show that obtaining the exemption and credit here was not a major purpose for the split-off. *Coastal Oil Storage Co.,* 25 TC No. 156.

Sales by officer attributed to corporation; they are dividends to her. Decedent was the sole stockholder of National Thread Co. from 1916 until 1944, when she transferred all her stock to her husband. Sales of over $156,000 made by him as an individual during the years 1942-45, as well as some $22,000 of unidentified bank deposits in his and decedent's name, are held to be in substance sales of National Thread and taxable to it. The proceeds are also held to represent distributions in the nature of constructive dividends to decedent and her husband, taxable as ordinary income to the extent of the corporate earnings and profits. *Stein Estate,* 25 TC No. 109.

Payment to former director is wholly non-deductible stock redemption. The taxpayer, a closely-held corporation, agreed to "buy out" an officer and director who owned stock and whose wife held debentures. He was paid a total of $120,000. The taxpayer claimed that $24,000, the excess of $120,000 over the book value of the stock and debentures, was deductible as paid in cancellation of his employment contract. The Tax Court held that the director had no contract, the parties made no allocation of the $120,000, and the record does not justify the claim for a deduction. This court affirms. *S. Blechman & Sons, Inc.,* CA-2, 2/6/56.

"Liquidation" really a reorganization; proceeds are "boot" and a dividend. Taxpayers owned 80% of the stock in a Tennessee Pontiac agency. The general manager, who owned the other 20% of the stock, decided to retire. Pursuant to its terms, the General Motors dealership agreement was cancellable on his retirement. A new corporation was organized, with the taxpayers owning almost all the stock. The old corporation transferred some of its assets at book value to the new, and distributed the balance in liquidation. The Commissioner argued that the effect of the series of transactions was a reorganization plan, and the assets distributed by the old corporation were "boot" and taxable as a dividend. This court agrees, both on the ground raised by the Commissioner and also on the Tax Court's further view that the net effect of the whole transaction was to continue the business with a withdrawal of a substantial part of the old corporation's surplus. The fact that a minority shareholder was bought out as part of the transaction did not alter this conclusion. The court did reduce the dividend, however, by the amount which the taxpayers invested in the new corporation, on the theory that that amount, was, in effect, transferred from the old corporation and remained in the business. *Liddon,* CA-6, 2/11/56.

Section 102 tax sustained; corporation fails to meet burden of proof (old law). A sand and gravel corporation is held subject to the imposition of the Section 102 penalty surtax for the years 1945 to 1950, having failed to show that its accumulated earnings and reserves of over $6,000,000 were not in excess of the reasonable needs of the business. Taxpayer claimed it needed reserves as a self-insurer, but offered no evidence of the amount. A report on proposed expansion was prepared in 1953 and was obviously based on conditions and plans long after the years in question. The reserves set up on the books for expansion and other contingencies were far less than amounts claimed here as reasonable. It was admitted that the failure to distribute earnings saved the controlling stockholders almost $1,200,000. [Under the 1954 Code, the burden of proof is on the Commissioner. *Ed.*] *Smoot Sand & Gravel Corp.,* TCM 1956-82.

Date rezoning becomes final starts 3-year period to determine collapsibility. Taxpayer had to have land rezoned from residential to commercial in order to construct a shopping center. This was contested over a period of years. For purposes of applying Section 341 relating to collapsible corporations, the rezoning is an integral step in the construction of the center. The 3-year holding period is held to begin on the day following the date rezoning became final if the corporation has no other construction activity with relation to the land after the date the rezoning became final. *Rev. Rul.* 56-137.

Corporation, engaged in litigation, continues for tax purposes despite formal dissolution. Taxpayer-corporation was engaged in extensive litigation alleging that a number of steel companies infringed its patents. In 1945 several steel companies agreed to settle by paying $9 million. At this point one of the stockholders, a bank holding 151 shares as trustee of a charitable trust, offered to buy the remaining 1849 shares from the other stockholders for about $11 million. As of the end of December the shares were sold and the corporation filed formal dissolution papers and assigned all its assets in liquidation to the trustee as stockholder. Litigation continued, and not until 1949 were all the suits settled and some $15 million released to the trustee. The Commissioner taxed this all as income of the corporation in 1949. The court agrees as to $12 million of it. In view of the extensive litigation the corporation must be regarded as still in existence for tax purposes also. However, some $3 million of the amount collected was for production after 12/29/45, the date of the assignment of the patents; that amount is income of the trustee. The rest was earned but not accruable at 12/29/45 and is income of the corporation. *Cold Metal Process Co.,* 25 TC No. 160.

Redemption of stock is a partial liquidation though not "cancelled" on books. [*Acquiescence.*] In 1940 a corporation in which taxpayer was a stockholder had operating assets of $135,000. By the end of 1948 the assets had been reduced to $7,000 by sales. The corporation redeemed all the stock of one of the founders in 1943, and in 1948 it redeemed all the stock of a co-founder, leaving taxpayer owning all the 200 shares outstanding. It then redeemed 100 shares of taxpayer's stock. The Tax Court, noting that the redemption occurred when the bulk of the corporate surplus consisted of insurance proceeds received on the death of a founder, held it to be in pursuance of a policy of gradual liquidation; it was not essentially equivalent to a dividend. The stock was considered "redeemed" even though kept on the books as treasury stock, since the corporation had no intention of reissuing it. *McDaniel,* 25 TC No. 39, *acq.* IRB 1956-11.

MANAGEMENT OF THE
Professional tax practice
AND PROFESSIONAL AFFAIRS OF LAWYERS & ACCOUNTANTS

How to use a financial analysis in estate planning: expert accounting services needed

by **RENE A. WORMSER**

If accountants were more active in estate planning we would get better financial analyses. This would tend to eliminate in advance many extremely trying problems, including planning the need for cash, valuation, planning for sale or control of a business, and expected shrinkage in assets. Mr. Wormser, a member of the New York bar and a leading writer on taxation of estates and related matters, here makes a plea for greater participation by the accountant in the estate planning job.

ALTHOUGH ESTATE PLANNING is basically a lawyer's job, he needs the collaboration or assistance of contributive specialists. Of these collateral experts, the one least used in practice is the accountant—a circumstance which is often most regrettable for both attorney and client, and deprives accountants of employment for which they are uniquely fitted. The explanation may be that accountants generally have not familiarized themselves with estate planning or have not made themselves conspicuously available to give technical aid in this field.

The accountant is best qualified to set up that preliminary analysis of the prospective estate which is prerequisite to devising a realistic plan. Indeed, he can often provoke the whole estate planning process by initiating such an analysis, from which it is very likely to appear that major planning is badly needed. Opportunities for initiating an analysis can occur readily enough in the course of normal accounting services to a client.

The client rarely has any clear idea what actual net estate would be available for use at his death. More often than not, he will begin to understand some of his most troublesome problems only after the assets and debts have been appraised with reasonable accuracy, adjustments have been made for expected administration expense and death taxes, and a balance has been struck. But he cannot plan with a mere net dollar sum in mind. He must deal with the net assets as they are. Therefore, a second phase of the analysis of his prospective estate consists of allocating selected assets for liquidation or for use to satisfy the shrinkage at death, due to debts, administration expense and taxes. The then identifiable residual assets are those with which a plan may deal.

This procedure is tentative, of course. It may turn out to be desirable, for special reasons, to retain some items which were initially labelled for liquidation. Some reorganization of assets, some substitutes or amplifications, may be indicated as the planning progresses. A general shifting around of the pieces usually precedes fitting them into a final mosaic. However, the preliminary analysis conduces realism; it is revealing to the client; it is suggestive to the man who is to model and propose a comprehensive estate plan.

The accountant is peculiarly equipped to set up this initial analysis which must base intelligent planning, though he, in turn, may need other expert collaboration in his own work. To illustrate what is involved in an analysis, I shall use an artificial case which I designed for a class at New York University. It is the case of the fictitious Mr. Charles F. Ogg, a man of means who has, among his assets and liabilities, items of diverse character. In Exhibit I, I have used nice round numbers in evaluations to save complex computation.[1]

The values which I have used are meant to represent the results of appraisals. Were this an actual case, a variety of appraisal problems would be raised. The accountant could readily evaluate some of the assets. Specialized experts would be needed to assess the value of others; the paintings and the real estate are obvious examples. Insurance policies should be checked by an insurance underwriter, lest there be features which would escape the uninitiated. Some documents, such as trust agreements and contracts, would require inspection by an attorney to determine their true character and significance, both from a legal and a tax standpoint; it is certainly never safe to rely on descriptions hazarded by the client himself.

Mr. Ogg's most valuable assets are the business interests, and an appraisal of these is most important. An accountant can usually make a pretty good stab at a corporate appraisal sufficient for initial use in estate planning. It may later become necessary to review and re-check such a tentative job, and even to call in a specialist for this sole purpose. But if the accountant makes his appraisal on the conservative side, it will often do for the purposes of the initial analysis.

The closely-held-stock problem

There are no valid formulae for the estate tax appraisal of closely held stock interests. Each is a case by itself. Comparative values of other corporations may be a guide; generally, however, no comparable company can be found whose stock is traded. The conventional and necessary start seems to be to compute a true balance sheet and true average earnings over a five year period, making what readjustments realism and fairness require. It is not to be presumed that government auditors will accept balance sheets and profit and loss statements at their face if reasonable digging would disclose hidden or undervalued assets, or bookkeeping practices which fail to reflect true earnings. On the other hand, adjustments in the other direction

[1] Lawyers are not always good at "figgerin' ", but, in defense of my profession, I must add that I have known excellent accountants who could not add.

may be indicated. There may be overvaluations and other factors which reduce asset value or earnings.

The government tries whenever it can to superimpose an item of goodwill on book value in appraising closely held stock. It is now a rare case, however, in which the government persists in this approach. It must face the fact that many listed corporations today still sell below their book value. It is usually safe to take book value, properly adjusted, as the maximum expected estate tax evaluation, unless the earnings are fantastic or the corporation is one in which capital plays a relatively minor part in the production of income; in such instances, a fair capitalization of average earnings may be the appraisal answer. Moreover, there are often special circumstances present which can be relied upon to result in some discount even from book value, such as the minority character of the holding; the unique and irreplaceable contribution of the stockholder; trends and conditions in the trade and in the individual business; contract and other involvements; peculiar hazards of the particular enterprise, etc.

The appraisal of a business interest can be a very complex process; it is inevitably a precarious one, involving elements of judgment. At any rate, of those experts who contribute to an estate plan, the accountant should be the most qualified to make such appraisal as may be useful up to the point where specialized appraisal services are indicated.

Accountant's record very useful

During the listing and appraisal phase of the analysis, the accountant can make a set of extremely valuable notes for his own guidance and for the future use of the attorney and others who are to collaborate in finishing the estate planning job. Innumerable precious data might be listed, such as control factors in corporations; agreements which may effect management or disposition; cost data; the time and method of acquisition of assets; the state of liquidity of corporations in anticipation of the use of Section 303 of the Code; carrying and maintenance cost of real estate or other assets; personal income data; standard of living requirements; gift tax history, etc. Moreover, inasmuch as the analysis constitutes an audit of the client's personal affairs, it would be an unusual case in which the accountant did not find frailties, inconsistencies, or downright flaws in the client's financial affairs.

Having set up realistic values, there comes the computation of shrinkage; the computation of the net estate; and preparation for the identification of the assets which are to be used to satisfy the shrinkage. Exhibit II is the way this could be set up in the Ogg case.

We now know, even using the maximum marital deduction, that the available liquid assets (or assets such as insurance which can be readily made liquid) come very far from giving us adequate liquidity at death. Assuming that there are to be no cash bequests, etc., we still need to liquidate or provide for an additional $400,000—and, if no marital deduction is to be used, then $804,400.

It may well be that we shall end with a plan which provides all or most of the liquidity deficit through other means. But it is instructive first to look the assets over to see what would have to be liquidated to satisfy the deficit if no extraordinary planning were done. This, then, would present the possibilities, for we happen to know that Mr. Ogg wishes to preserve his major business for his family.

Asset	To be liquidated?	To be retained?
Personal effects		$ 20,000 (passing to wife?)
Paintings	$ 50,000	
Ogg Mfg. stock		1,400,000
Franklin Sales stock	175,000	
Ogg & Brass interest	250,000	
Home		50,000
Acreage	10,000	
Patent	30,000	
	$515,000	

Where are we, then, regarding liquida-

EXHIBIT I: MR. OGG'S FINANCIAL PICTURE

A. Assets and Items With Which Mr. Ogg Can Plan.	
Personal effects, miscellaneous	$ 20,000
4 Valuable Paintings	50,000
Cash in banks	15,000
Marketable securities (see Schedule A)[2]	55,000
7000 shares stock in Ogg Mfg. Co. Inc. (See Schedule B)	1,400,000
1750 shares stock in Franklin Sales Co. (See Schedule C)	175,000
½ partnership interest in Ogg & Brass (See Schedule D)	250,000
Home in New York City (equity)	50,000
Acreage in Westchester	10,000
Patent (See Schedule E)	30,000
Ordinary life insurance—principal (See Schedule F)	50,000
Retirement insurance—principal value (See Schedule F)	50,000
Joint and survivorship annuity—death value (See Schedule F)	20,000
Irrevocable trust established by Ogg but in which he retains no rights or interest (See Schedule G)	200,000
B. His Liabilities and Obligations.	
Average household bills outstanding	2,000
Loan with securities as collateral	25,000
Loan with insurance as collateral	15,000
Current and contingent income taxes	22,000
Contingent obligation on endorsed note; almost certain to mature	15,000
Estimated medical and funeral expenses at death	5,000
Estate administrative expense and general estimated shrinkage	.....
Death taxes	.....
C. Assets of Mrs. Ogg.	
Cash in banks	3,000
Summer residence in Conn. (See Schedule H)	20,000
Personal effects	20,000
Stock in Ogg Mfg. Co. Inc. (See Schedule B)	400,000
Miscellaneous securities	15,000
(No substantial obligations or shrinkage except in case of death)	

[2] I am not reproducing the various detailed schedules which are referred to in the statement. These would give detailed necessary information regarding individual assets. The compilation and assembling of these schedules would in most instances be uniquely the province of an accountant. I am not showing either such memoranda regarding family relations, Mr. Ogg's selected objectives, etc., which are not necessary for the current discussion. These would normally be compiled by the attorney.

tion? Having used up all of our liquid assets, we still need an additional $804,400 if we are to use no marital deduction—yet the remaining items in the list of assets which we may be willing to dispose of but which are in varying degrees frigid (first column above) aggregate only $515,000. Even if we use the full marital deduction, we are in some difficulty. True, we need only an additional $400,000 and have $515,000 in the first column. But which of these frigid items to plan to liquidate and how is indeed a problem.

Using no marital deduction, we need to liquidate part of the precious Ogg Mfg. shares, which gives rise to various difficulties—danger of loss of control, etc. Using the full marital deduction, we have difficult liquidation problems and, are left, at best, only with the Ogg Mfg. stock, the home, the personal effects, and $115,000 of assets, a good part of which may be frigid and undesirable to hold.

This analysis reveals problems

Clearly enough, the very sight of this analysis will bring serious problems to mind. Many highly interesting solutions of such problems are available to us, and the analysis in itself will begin to suggest selections out of the available

EXHIBIT II: THE COMPUTATIONS OF SHRINKAGE

Assets	*Taxable*		*Non-Taxable*	*Liquid*
Personal effects	$ 20,000			
Four paintings	50,000			
Cash	15,000			15,000
Marketable securities	55,000			55,000
Stock in Ogg Mfg. Co.	1,400,000			
Stock in Franklin Sales Co.	175,000			
Partnership interest, Ogg & Brass	250,000			
Home (equity)	50,000			
Acreage	10,000			
Ordinary life insurance	50,000			50,000
Retirement policies	50,000			50,000
Joint and survivorship annuity	20,000			20,000
Patent	30,000			
Irrevocable trust (no retained interest)			200,000	
		$2,175,000	$200,000	$190,000
Expected debts and administration expense				
Household bills	2,000			
Loan against collateral securities	25,000			
Loan against insurance collat.	15,000			
Contingent and current income tax	22,000			
Contingent obligation on endorsed note	15,000			
Medical and funeral	5,000			
Administrative expense and general administrative shrinkage, estimated at 10% of gross estate	217,500	301,500		
NET ESTATE SUBJECT TO TAX		$1,873,500		
Maximum marital deduction (½)		936,750		
DEATH TAXES WITH MAX. MAR. DEDUC.			$288,500	
DEATH TAXES WITH NO MARITAL DEDUCTION			692,900	

COMPUTATION TO DETERMINE DEGREE OF LIQUIDITY

Liquid Needs	*If full marital deduction used*	*If no marital deduction used*
Debts and administration expense	$301,500	$301,500
Death taxes	288,500	692,900
Total	590,000	994,400
Liquid Assets	190,000	190,000
DEFICIT IN LIQUIDITY	$400,000	$804,400

(Plus any cash needed for bequests, etc.)

NOTES TO EXHIBIT II:

(A) In appraising assets, two resultant figures must be obtained for some items—(1) value for estate tax purposes, i.e. tax value, and (2) value for estate planning use. In some cases the item may be wholly available for use in the estate but only partially taxed; or vice versa.

(B) In making the tax computation, it must be kept in mind that many items of property might be subject to tax in the client's estate, though not passing under his will or even necessarily appearing on his personal balance sheet. Examples might be a taxable power of appointment under someone else's instrument; transferred insurance in which more than a 5% reversion has been retained; etc. Assembling such items requires digging, and consultations with counsel to determine legal effect and taxability.

(C) Administrative shrinkage is set high at 10%. Ordinarily, 7% or 8% should be adequate. In the Ogg case, however, it was anticipated that he would probably wish three executors, consuming an aggregate of slightly over 6% of the estate in their fees. Adding a probable attorney's fee of 3%, leaves a balance for "miscellaneous" of 1%.

(D) I have computed the death taxes in two ways; using no marital deduction and using the maximum marital deduction. This is always wise; to give the range of liquidation necessity.

(E) The "liquid needs" shown at the end of the computation would have to be increased by whatever cash bequests and disbursements the client were to direct in his will.

methods which best suit the particular case. Reductions of the estate tax impact through gifts; the use of Section 303; agreements with fellow-stockholders and business associates; amplifications of the insurance program; the creation of special trusts; even the creation of a foundation; these and many other avenues of attack are possible.

We have not only the shrinkage-liquidation problem, but also the major objectives of the client to consider. Liquidation and reorganization methods must be coordinated with these, to produce the most practicable and desirable dual result—the solution of the liquidation problem and the most reasonable, economical and effective satisfaction of the client's desires.

It is difficult to see how either part of this dual result can be reached without having first gone through such an analysis of the expected estate as it stands.

Nor is the analysis of the client's estate alone all that is required. The prospective estate of the wife must be similarly analyzed, and, in some instances, those of the children. Incomes must be computed, before and after taxes; living requirements must be fairly assessed to determine whether any margin of incomes remain for use.

I shall not attempt to go into the many other factors, financial and personal, which come into play once the preliminary analysis of a prospective estate has been made. It would require telling a large part of the whole story of estate planning. I do call to the attention of accountants, however, the extremely valuable part they can perform in estate planning, in taking over or actively assisting in the analysis of a prospective estate, an activity in which the accountant's peculiar capacities are of especial value. ☆

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TAX PLANNING AND
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EDITED BY CHARLES S. LOWRIMORE, Sr., CPA

What loans can an employee's trust make to the employer?

AS A PRACTICAL MATTER, many small businesses considering employees' pension and profit-sharing plans (particularly the latter) are much concerned with the possibility of borrowing from the fund. Isadore Goodman, Assistant Chief, Pension and Exempt Organizations Branch of the IRS, went into this in some detail at the San Francisco meeting of the Western Pension Conference last fall. He had this to say:

Apparently the most far-reaching change in the area of retirement plans brought about by the 1954 Code consists of making employees' trusts subject to provisions which are applicable to exempt organizations pertaining to feeder organizations and prohibited transactions. Exemption may be denied if the organization engages in prohibited transactions. Such transactions are enumerated in Section 503 (c) and consist of dealings between the exempt organization and the employer who established it, or related or controlled interests, involving:

1. A loan of any part of the organization's income or corpus without the receipt of adequate security and a reasonable rate of interest;

2. Payment by the organization of compensation in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered;

3. Making any part of the organization's services available on a preferential basis;

4. Any substantial purchase by the organization for more than an adequate consideration in money or money's worth;

5. A sale of any substantial part of the organization's securities or other property for less than an adequate consideration in money or money's worth; and

6. Any other transaction which results in a substantial diversion of the organization's income or corpus.

These provisions apply to exempt organizations generally, and have also been made applicable to employees' trusts. But only about half result in important consequences; the rest are probably academic. The most potent provisions are: (1) A loan of funds without the receipt of adequate security and a reasonable rate of interest, (2) buying securities or other property at a price in excess of fair market value, and (3) selling securities or other property at a price below fair market value. It is possible that the other restrictions may apply at times, but the operation of pension and profit-sharing plans is such that it is not likely that situations would arise with respect to which those restrictions would be applicable. For example, an employer may be the trustee of its employees' trust; if it should charge a fee in excess of the prevailing rate, that would be subject to a determination as to whether a prohibited transaction is involved. It would be unusual, however, for an employer who makes a contribution, which is deductible wihin specified limits, to try to get some of it back by exorbitant charges which would constitute taxable income. Similarly, it isn't likely for an employees' trust to make any of its services available on a preferential basis since the trust is not a service organization.

As to purchases or sales involving transactions with the creator of the trust, or with related or controlled interests, the problem is one of valuation. Fair market value at the time of the transaction governs. In the case of listed securities, the determination is simple. In other cases, appraisals by experts may be necessary. If the trust loans some of its funds to the employer at an interest rate of 4%, while the prevailing rate of

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interest for similar loans in the community where the parties are situated is 5%, the loan may be considered a prohibited transaction, even though the 5% rate is reasonable.

"Adequate security" has not as yet been officially defined. Section 503(c) of the 1954 Code corresponds to Section 3813 (b) of the 1939 Code. The Regulations on the latter section do not define the term "adequate security" nor do they illustrate its application. The committee reports on the 1954 Code do not shed much light on the matter either. House Report No. 1337, accompanying H.R. 8300, 83rd Congress, 2nd Session, in referring to Section 503, at page A169, merely states in this regard: "For example, if the trust loaned any part of its income or corpus to the employer-creator of the trust without the receipt of adequate security and a reasonable rate of interest, it would lose its exempt status." A similar statement is contained in Senate Report No. 1622, at page 310. Consequently, the question remains, "What is adequate security?" Regulations under the 1954 Code on sections dealing with exempt organizations are pending. Until they are officially promulgated no definitive position can be stated. Certain opinions, however, have been advanced and these may be considered.

A simple note may not do

There is one school which contends that "security" means an investment represented by an evidence of debt or ownership, such as stocks, bonds, or notes. Hence, the promissory note of a financially sound employer should seem to satisfy the statutory requirement. See comment on financial condition of the employer, return Form 990-P. That is one view. Apparently, however, there is some doubt as to its efficacy. A bill has been introduced (HR 7151) providing "approval of an independent banking trustee based upon the credit standing of the obligor" as an alternative requirement to "adequate security."

Another view is that "security" is something of value supporting a promise to pay and is in addition to a showing of ability to make repayment. It may consist of collateral, a lien against specific property, or assurance of repayment by a solvent guarantor or surety. Under this view, a loan of $100,000 by an exempt organization to the grantor who has a net worth of $500,000, merely on his own promissory note, is not a secured loan. If, however, the note is accompanied by a mortgage on property, or collateral, or carries with it the secondary promise of repayment by a solvent accommodation endorser, it may be secured.

The security must be adequate. That is, the security at the time of the transaction must be sufficient to repay the indebtedness, interest, and charges which may pertain thereto. If the fair market value of the mortgaged property, or collateral, is $75,000 against an indebtedness of $100,000, the security is inadequate, unless there is adequate security or endorsement. Similarly, if an accommodation endorser's net worth is $75,000, his endorsement on a note for $100,000 is not adequate security for purposes of avoiding this problem.

Debenture bonds which are not secured by mortgaged property are mere evidences of indebtedness and, in accordance with the aforesaid view, do not constitute security within the purview of Section 503 (c) (1). Similarly, subordinated debenture bonds of a partnership which are guaranteed by the general partners would not be adequately secured. Since the general partners are liable for the firm's debts, their guaranty does not add anything to what the creditor already has.

The security must be actual and realizable and not a mere possibility for receiving greater payment. A promise to repay the loan plus a percentage of future profits which may be greater than the prevailing rate of interest does not meet the requirement for adequate security. Neither is a judgment note adequate security. It merely facilitates collection in some cases. A note in which the debtor confesses judgment in the event of default enables the creditor to enter judgment without suit and may give him a priority in collection but it does not, by itself, constitute adequate security.

In the case of junior mortgages, a greater margin of security may be necessary in order to provide a sufficient recoverable interest in the event of foreclosure by the holder of the prior lien.

The provisions relative to prohibited transactions are applicable to employees' trusts after March 1, 1954. In the case of a loan made prior to such date, without adequate security or a reasonable rate of interest, if any part of the loan is repayable before December 31, 1955, it may be refinanced on the same

(Continued on page 385)

NEW DEVELOPMENTS IN TAX ASPECTS OF

Accounting

EDITED BY CARL M. ESENOFF, CPA, & C. W. LAMDEN, Ph.D., CPA

1954 Code seems to fail, unexpectedly, to correct inequity in property-tax reduction

by **NELSON H. C. LOW**

CAREFUL READING and re-reading of the statute and the various committee reports has forced this writer to the conclusion that the mandatory tax-apportionment requirement of Section 164 (d) was not intended by Congress, whether on purpose or by oversight, to apply to the treatment of the property tax which is a lien on the sale date but which relates to a different property-tax year than the one in which the sale occurs. (Paragraph 1460.01, Vol I, of the 1956 CCH's *Standard Federal Tax Reporter* says, concerning taxes accrued prior to the sale date:

"The taxes are considered as imposed upon the seller up to, but not including, the date of sale, whether or not they accrue or become a lien before or after such date; likewise, the buyer is treated as the person upon whom the taxes are imposed, beginning with the date of the sale, regardless of the accrual date or lien date under local law.")

The rules are thus made to treat all property taxes accrued prior to the sale date as coming within the ambit of Section 164(d), but this, it seems to the writer, is not proper. Both the provisions of Section 164(d) and the committee reports aim only at the property taxes for the property-tax year in which the sale occurs.

Difficulties under the 1939 Code

Under the Internal Revenue Code of 1939 a purchaser of real estate was denied a deduction for the pro-rata share of the local property taxes which he assumed in the purchase contract and paid, if under local law the taxes had become a personal liability of the seller prior to the date of sale. This result was brought about by the now-familiar principle, enunciated by the Supreme Court in *Magruder v. Supplee* [316 U.S. 394 (1942)], that either a pre-existing property tax lien or personal liability therefor on the part of a seller is sufficient to foreclose a subsequent purchaser, who pays the amount necessary to discharge the tax liability, from deducting the payment as a "tax paid." Under this doctrine the purchaser was required to capitalize the portion of the tax he paid in the basis of the property purchased; the seller was entitled to deduct the taxes.

To correct this inequitable sittuation, Congress enacted Section 164 (d) of the Internal Revenue Code of 1954. Briefly stated, upon the sale of real property after 1953, the purchaser is considered as the person on whom the tax is imposed for that portion of the real property tax year in which the sale occurs beginning on the date of the closing of the sale; and that part of the tax allocable to the portion of the same real-property-tax year preceding the date of closing sale is deemed to be imposed on the seller. It was predicted that justice would henceforth be done to both parties to the transaction in all cases by this mandatory apportionment requirement, thus rendering the *Supplee* doctrine obsolete.

Despite this announced intention to remove the inequities of the prior law, this writer believes that the corrective provisions of the new Section 164(d) are incapable of meting out justice in certain cases where the lien dates of the local property tax precede the local property tax years to which such tax relates. The *Magruder v. Supplee* decision has definitely not been legislated into complete oblivion.

Sale not in property-tax year

Take the hypothetical, though highly typical, case of a California seller and a California purchaser of real property situated within the county limits of Los Angeles. The California property-tax year commences July 1 and ends on June 30 of the succeeding year[1] and the lien date for California property taxes is the first Monday in March preceding the property tax year. For instance, the real-property tax for the property-tax year from July 1, 1955 to June 30, 1956 became a lien on the assessed real property and, therefore, accruable for federal income-tax purposes on March 7, 1955. Now, our hypothetical seller sold his real property on June 1, 1955. What tax consequences would this sale entail under the provisions of the new Section 164 (d)?

Since the property was sold during the property-tax year 1954-55, it is abundantly clear under Subsection (d) (1) or (2) that approximately 1/12 of the 1954-55 property tax, which became a lien on the property and accrued on March 1, 1954, would be treated as having been imposed on the purchaser and, therefore, deductible by him, whether he be on the cash or accrual basis for federal income-tax purposes. Assuming that the Los Angeles seller had derived tax benefits from deducting the entire 1954-55 tax for a prior taxable year, he would now be required to include 1/12 of such deduction in his gross income for his taxable year during which the sale occurred. So far, Section 164 (d) has served well the intent of its framers to circumvent *Magruder v. Supplee*. But unfortunately, it also has reached the end of its powers.

On June 1, 1955, the date of sale, the real property was encumbered with the entire amount of the 1955-56 property tax which became a lien on March 7, 1955, as pointed out above. Under the *Supplee* doctrine, inasmuch as the tax was a lien against the property on the sale date, it must be treated as part of the selling price, and the seller, not the purchaser who may pay the tax subsequent to the purchase, would be en-

titled to deduct the entire amount of the 1955-56 tax. This writer has no doubt that this represents one of the inequities resulting from the application of the *Supplee* rule that Congress sought to eliminate by the enactment of Section 164 (d). But does the statute, as it now stands enacted in Section 164 (d), overturn *Magruder v. Supplee* with respect to the treatment of the property tax which is a lien against the property on the sale date, but which relates to a property tax year that succeeds the property tax year in which the sale occurs? Unless it does, *Supplee* rules supreme.[2]

Scope of the 1954 Code

The general rule for apportionment of taxes under Paragraph (1) of Section 164 (d) applies only to real-property tax for any real-property tax year during which the real property is sold. The special rules under Paragraph (2) deal with the tax which is treated under Paragraph (1) as having been imposed on the taxpayer.[3] Since both the general and special rules are silent regarding the treatment given to property tax as attributable to other than the property-tax year of sale, the conclusion must be that the treatment of such property tax is governed by the *Supplee* decision. Nowhere in the statute is there even the faintest suggestion that such tax might be subject to the provisions of Section 164 (d). In fact, there is explicit language in the Senate Committee Report that the law existing prior to the enactment of the 1954 Code would govern the treatment of the deduction of taxes under similar circumstances, although it is extremely doubtful that it was directed consciously at situations such as those confronting our hypothetical seller and purchaser in Los Angeles County.[4]

If this writer's contentions in this respect should prove to be correct, our California purchaser would have to capitalize the 1955-56 property tax which was a lien against the property he bought on June 1, 1955 and which he would or might pay subsequent to June 1, 1955. This result would obtain whether he be a cash-basis or accrual-basis taxpayer.[5] In our hypothetical case of the 13 months' property tax relating to the period of ownership of the property by the purchaser from June 1, 1955 to June 30, 1956, which undoubtedly is not only theoretically and equitably, but also actually and financially, attributed to him, but for the tyranny of *Magruder v. Supplee*, the corrective provisions of Section 164 (d) could award him only 1/13: he would be able to deduct for federal income-tax purposes only 1/13 of the 13 months' tax he was charged with and required to pay in the purchase transaction. The remaining 12/13 of the tax, in spite of Section 164 (d), he appears to have no choice but to capitalize. Since in California the annual property-tax lien date precedes the related property-tax year by approximately 4 months, the *Supplee* rule seems capable of nullifying the effectiveness of Section 164(d) with respect to all sales of realty transacted during those 4 months.[6]

Admittedly, such an outcome, for California taxpayers as well as for taxpayers of many other states having similar property tax laws, is highly anomalous, especially in view of the spirit with which the statute was framed and the avowed Congressional intent to sidetrack *Supplee* by its enactment for

[*Nelson H. C. Low, Ph.D., CPA, is a member of the tax staff of Finkel and Finkel, Los Angeles accounting firm. The opinion expressed in the above article is entirely his own.*]

[1] The term "real property tax year" is not defined in the statute. Nowhere in the committee reports is there contained any reference as to what is meant by the "real property tax year" in terms of the levying statutes of the local authorities. For California taxpayers such "real property tax year" has always been understood to coincide with their state's fiscal year commencing July 1. (Article XX, Section 5 of State Constitution.) Upon adoption of budget by the county board of supervisors, the rate of county and district taxes is determined for the current fiscal year. The form of bills sent out by the various taxing districts indicates that such payment of the tax relates to the fiscal year beginning July 1 in which the tax is levied and ending June 30 of the succeeding year. However, Section 118 of the California Revenue and Taxation Code also gives the definition of the so-called "assessment year" which begins with one lien date and ends immediately prior to the succeeding lien date. Now, if the "real property tax year" as the term is used in the Federal statute should eventually be held to coincide with the assessment year, the difficult problems raised in this article would not arise in practice at all. But to identify the statutory term "real property tax year" with the assessment year of the California Code would be incompatible not only with California usages, but also with such decisions as *California Sanitary Co., Ltd.*, 32 BTA 122; *Crown Zellerback Corp. et al.*, 43 BTA 541, dismissed (CCA-9; 1942) 30 AFTR 1630; *Estate of Stella H. Lick, Deceased*, Paragraph 41,025 P-H Memo BTA; and *Frank A. Miller*, Paragraph 41,137 P-H Memo BTA. The unanimous holding of all these cases has been that for federal income-tax purposes, the property tax for the property-tax year became a lien on the property on the first Monday in March preceding such property tax year and was therefore accruable on that date. Throughout this article, therefore, the "real property tax year" for California is presumed to be the state fiscal year beginning July 1.

[2] Senate Committee Report, 83d Cong., 2d Sess., S. Rep. No. 1622 (1954), p. 305. It is realized that this reference has to do with the prescription of the 1939 law for treatment of property-tax deductions for accrual-basis taxpayers even under the 1954 Code if they do not elect to accrue property tax on a pro-rata basis as provided for under Section 461(c). By analogy, however, this writer thinks that it is correct to presume that in the case Section 164(d) does not apply, *Supplee* governs.

[3] Portions of Section 164(d) pertinent to our discussion here are quoted below:

"(d) . . . .

(1) General Rule.—For purposes of subsection (a) [regarding allowance of deduction for taxes], *if real property is sold during any real property tax year, then*—

(A) *so much of the real property tax as is properly allocable to that part of such year* . . . .

(B) *so much of such tax as is properly allocable to that part of such year* . . . .

(2) Special Rules—

(A) In the case of any sale of real property, if—

(i). . . .

(ii) *the other party to the sale is (under the law imposing the real property tax) liable for the real property tax for the real property tax year*, . . . the taxpayer shall be treated as having paid, on the date of the sale, *so much of such tax as, under paragraph (1) of this subsection*, is treated as imposed on the taxpayer . . . .

(D) In the case of any sale of real property . . . then, for purposes of subsection (a), *that portion of such tax which*—

(i) *is treated, under paragraph (1) of this subsection, as imposed on the taxpayer*, and

(ii) . . . . shall be treated as having accrued on the date of the sale." (Emphasis supplied.)

Both the general and special rules refer unmistakably to the treatment of property tax for the property-tax year of sale only.

[4] The following is quoted from Senate Committee Report, 83d Cong., 2d Sess., S. Rep. No. 166 (154), p. 197:

"By reason of the change made in section 461(c) by your committee, which makes ratable accrual of real property taxes an elective rule, there has been added a special rule in subsection (d)(3) for sales of real property involving taxpayers on an accrual basis who have not elected to accrue real property taxes ratably. *In the case of the sale of real property involving such taxpayers the apportionment rule provided by subsection (d) will not be available. In those cases the rule of existing law on treatment of the deduction of taxes will be applied. Thus if an accrual basis taxpayer has before the sale accrued the taxes on the lien date, the other party to the sale who may in fact pay the taxes may add the taxes so paid to his basis* . . . ." (Emphasis supplied.)

It might be argued that the quoted portion of the Senate Report fits our situation on four squares and therefore, there need not be any argument as to whether or not the purchaser can deduct the 1955-56 tax which was a lien against the purchased property as of March 7, 1955. The answer would be: No, he cannot. But beware of the fact that the Senate in this connection was concerned only with accrual-basis sellers who had not elected the provisions of Section 461(c) and with the treatment of property tax of the property-tax year in which sale occurred. Had the Senate been concerned with our hypothetical California situation, it would have been aware of the fact that whether or not the seller or the purchaser or both were on the accrual basis of accounting who had not elected Section 461(c) would not have changed the result an iota. As long as Section 164(d) does not apply, the *Supplee* doctrine requires the capitalization by the purchaser of the property tax which is a lien against the property on the sale date, whether or not the seller or the purchaser is on the accrual basis or the cash basis, or both. It is thus concluded that in making the above quoted statements, the Senate was not dealing with the situations confronting us in this article. (The above-quoted portion of the Senate Report was subsequently amended in conference to allow the allocable tax to be treated as having accrued on the date of sale for the accrual-basis party to the transaction who under his method of accounting could not otherwise deduct such tax for any taxable year. (Conference Committee Report, 83d Cong., 2d Sess., H. Rep. No. 2543 (1954), p. 28.)

[5] The same result would obtain for the cash-basis or accrual-basis purchaser regardless of the seller's basis. We will not explore the possibility for an accrual-basis purchaser to elect to accrue property-tax deduction ratably over the property-tax year and be allowed such ratable deduction without regard to whether the seller is entitled to or has already made the deduction for such taxes. Some possibility in this connection exists by virtue of the language of Section 164(b)(7) and Section 461(c), but the Treasury's abhorrence of double deduction is likely to render slight possibility into complete impossibility. The seller's accounting basis for tax purposes affects only his time for reporting the additional gain and the additional tax deduction attributable to the tax lien.

[6] Of course, Section 164(d) remains effective with respect to any property tax allocable to those 4 months.

all sales of realty subsequent to 1953. But the writer is compelled to accept such an abnormal result by the language of the statute as it now stands and by the absence of any reference to the contrary in the Committee reports. Perhaps in the forthcoming Regulations the Treasury may attempt, by administrative interpretation to remove the remaining inequities of the prior law, perhaps by identifying the "real-property tax year" with the "assessment year" referred to above (at Footnote 1). However, in view of the well-nigh insurmountable difficulties that can be anticipated from such an administrative interpretation contrary to the existing state of announced judicial opinion, additional enabling legislation in this connection appears unavoidable. ☆

1955 Accounting Trends shows changes in accounting for taxes

THE AMERICAN INSTITUTE of Accountants recently put out its 1955 edition of *Accounting Trends & Techniques,* the annual cumulative survey of the accounting aspects of the published reports of over 600 corporations. Among the nuggets:

In 1954, 582 of the 600 survey companies disclosed in their balance-sheets a liability for income taxes. Of these, 361 used such terms as "estimated," "provision," "reserve," and "accrued" in describing such liability. The remaining 222 companiees merely set forth the type of liability without any further description. There has been a material increase (222 in 1954, compared with 173 in 1950) in the number of companies following this procedure.

The ownership of U. S. government securities was disclosed in the 1954 report of 372 companies. A substantial number of these (172 in 1954 and 179 in 1953) presented either all or some portion of such securities in their balance-sheets as a deduction from the liability for federal income taxes.

Income-tax adjustments

The Institute's *Restatement and Revision of Accounting Research Bulletins* recommended that adjustments of provisions for income taxes "should be included in the income statement unless they are so material as to have a distorting effect on net income; in such event they may be charged or credited to surplus with indication as to the period to which they relate." In this year's survey, 183 of the 600 companies presented a total of 245 such income-tax adjustment items. Of these 245 items, 179 were set forth in the income statement; 32 were disclosed either in footnotes or in the letter to the stockholders; and the remaining 34 were shown in the statement of retained earnings.

The income account was utilized for 211 income-tax adjustments by 160 companies; the retained-earnings account for 33 items by 29 companies; and unclassified surplus for one item by one company. A combination of such accounts was frequently employed. ☆

Making taxes clear in company's annual report

WE RECEIVED the annual report of Schering Corporation last month (Haskins & Sells, auditors) and found therein this very clear and interesting comment on the company's tax position:

"Federal income taxes amounted to $10.8 million or $6.14 per share. The relationship of this charge to total income before taxes is somewhat higher than normal because the Company has continued the practice adopted in 1954 of charging income with provisions for certain estimated expenses which are not currently deductible for Federal income tax purposes. Income has also been reduced by provisions for increased depreciation and payment in full of the balance of the past service liability to the Schering Corporation Retirement Plan which are not considered current year expenses for tax purposes. The amounts provided are such that when in future periods these expenses materialize or become tax deductible they probably will not affect net income after taxes. The retroactive repeal of the provision of the Internal Revenue Code of 1954 relating to the accrual of estimated expenses required the payment of $245,000 of additional taxes."

You can't get stepped-up basis by putting asset to new use; Parsons loophole closed

IT TOOK A LONG TIME and a lot of inflation to bring before the courts the question of how to compute depreciation on a residence converted to rental property at a time when its fair value is in excess of its cost. A District Court said "use the value at date of conversion"; the Third Circuit has just reversed.

Parsons (reported in 2 JTAX 237) purchased a residence in 1940 and converted it to income-producing property in 1949, at which time the fair market value of the house had almost doubled. He claimed depreciation on the 1949 value of the house. The Commissioner allowed only depreciation computed on the 1940 cost. Taxpayer sued for refund. The District Court for New Jersey held (126 F. Supp. 552), "The proper basis for computing depreciation is the fair market value of the depreciable property on the conversion date because original cost to the plaintiffs of the property did not reasonably reflect the 'value' of that property on the date of its conversion to an income producer."

Before the Appeals Court decision came down, Joseph E. Lane, Jr., in the *Alabama Law Review* analyzed the holding and pointed out that the cases cited by the district court were distinguishable. In his words:

Numerous cases support the proposition that the tax cost, or basis, for computing depreciation of a residence converted to income-producing property is fair market value at the time of such conversion, where such market value is less than original cost. This concept appears to have originated in *Heiner v. Tindle,* 276 U.S. 582 (1928), but as the court properly points out [in *Parsons*]: ". . . there the court was concerned only with the proper basis for computing the *loss* resulting from a *sale* of a residential property which had been converted into a profit-making business operation." We have a different situation here.

The court in reaching its decision relied on three cases: *Mary Louise Bok,* 46 BTA 678 (1942), *aff'd sub nom Helvering v. Bok,* 132 F.2d 365 (3rd Cir. 1942); *Ralph Perkins,* 41 BTA 1225 (1940), *aff'd,* 125 F. 2d 150 (6th Cir. 1942); *Charles J. Thatcher,* 24 BTA 1130 (1931). In none of these cases does it appear that when the conversion to

business use occurred the fair market value was greater than cost, and in *Ralph Perkins* the value at the time of conversion is stated to be less than cost. As each of these three cases cites *Heiner v. Tindle* in justification of its holding, it is doubtful that they are authority for the proposition that fair market value at the time of conversion is the proper basis for depreciation, when such fair market value is greater than cost.

In *Alfred M. Hickman,* citing *Mary Louise Bok,* the Tax Court said: "The fair market value of the depreciable asset represented by the house at date of its conversion to business use, *if not in excess of cost,* is the proper basis for depreciation." (Emphasis supplied.) While *Alfred M. Hickman* also involved property whose value was less than cost at the date of conversion to business use, the court in that case clearly recognized that the basis for depreciation should be fair market value of the property at the time of conversion only so long as the fair market value at the conversion date was less than cost. This case appears to be the first reported decision to attempt to extend this doctrine.

The court in *Parsons* based its decision on its understanding of the word "cost", as used in the 1939 Code, Section 113(a), as meaning value at the conversion date. Is the cost of the house after its conversion to rental property different from its cost prior to that time? The *Parsons* case says the cost is different. Since the same taxpayer owned the house both before and after the conversion, such a conclusion is dubious.

Should the decision in *Parsons* be generally adopted, it could become the basis of an important tax-saving device. A taxpayer whose residence has a current value materially in excess of its original cost, and who wishes to dispose of the residence, would first rent it for a number of years, taking depreciation based on its value when it was converted to rental property; then when its original cost had been recovered through depreciation, it would be sold. The entire sale price would be treated as a long-term capital gain.

Third Circuit reverses

This loophole, or potential loophole, did not last long. As Mr. Lane had foreseen, the lower court decision was reversed. The Appeals court said:

The taxpayer's position is demonstrably unsound. He is treating the rental enterprise, to which he has newly committed his property, as if it were a taxpayer. It will hardly be disputed that "cost to the taxpayer" as represented by "the taxpayer's outlay is the measure of his recoupment through depreciation accruals." . . . But the rental business is not the taxpayer . . . The cost with which we are concerned is a concomitant of acquisition by a taxpayer. And a taxpayer cannot acquire what he already owns by devoting it to a new use. Consistent with this view, neither the taxpayer's research nor our own has revealed the one here on appeal allowing depreciation in excess of the taxpayer's actual outlay.

The taxpayer seeks to avoid this result by urging his view of the logic of certain depreciation cases in which the value of former residential property at the time of conversion to rental use has long been less than the taxpayer's original cost. It is true that in this situation the taxpayer cannot use a basis greater than market value on conversion for his projection and computation of depreciation . . . But there is a distinct reason for this. The depreciation conception is a conception of loss. The income tax laws take the depreciation of business property into account to the extent claimed and established as a loss sustained from year to year. Thus, total allowance for depreciation over the years cannot exceed the total loss which can be shown as a possibility over the entire period for which depreciation may be claimed . . . In the present case we are concerned with property which as a matter of law was not depreciable for tax purposes so long as the taxpayer used it for a residence. However, the taxpayer's cost, his capital investment in the structure, remains under Section 113(a) a limitation upon the total depreciation which may be allowable after conversion to business use. At the same time, because the value at the time of conversion represents the maximum loss that can be suffered during the entire period of allowable depreciation, that value also is a limitation.

If property has decreased in value between purchase and conversion this second limitation is the smaller amount and, therefore, is controlling. In the unusual situation of the present case where market value has increased between purchase and conversion without additional capital investment, the smaller capital outlay is the effective limitation. ☆

New accounting decisions this month

CAPITAL GAINS & LOSSES

Ordinary income on breeder's sale of yearling horses. A breeder of horses annually put up for auction sale all his yearling horses too immature for breeding. He arranged for a "reserve bid" or for someone to bid on horses he intended to retain. The court finds that the yearling horses sold were property held primarily for sale in his trade or business. An increase by the Commissioner in the useful life of the breeding horses from 12 to 16 years is held unwarranted. *Nowland,* TCM 1956-72.

Employee subdividing homestead finds himself in real-estate business. Taxpayer, a cashier in a meat market, acquired 11.55 acres of property under a patent granted by the Territory of Hawaii. He erected a house and rented out portions of his land as vegetable farms. When the character of the neighborhood changed, he engaged a licensed real-estate broker to subdivide the property and make improvements. Sales of the subdivided lots are held to result in ordinary income. *Achong,* TCM 1956-733.

Ordinary income on sale of used water coolers previously leased. Taxpayer leased and sold electric water, beer, and frosted-food coolers. It sold both new and used coolers from inventory, and sold some leased coolers to lessees. It conceded that its sale from inventory resulted in ordinary income, but contended that the coolers which were leased and then sold had been "used in the business," not "held for sale," so that they were capital assets. The court disagrees, finding that the taxpayer is in the business of both leasing and selling coolers, whichever was more advantageous, and no distinction could be made between the coolers sold from inventory and the ones sold while out on lease. The fact that rental income predominated did not alter the result, because there was no evidence that such a situation was anything but a normal characteristic of a rent-or-sell business in

the particular industry. *SEC Corporation,* DC NY, 3/8/56.

Transfer of some rights in copyright for indeterminate sum is license, not sale; ordinary income resulted. Taxpayer was a secretary of George Santayana, who, prior to 1942, had given the taxpayer his entire interest in his autobiography *Persons and Places.* In 1942, taxpayer entered into an agreement with Charles Scribner's Sons granting them the exclusive right to publish the book in the United States and Canada, but retaining the serial, motion picture, dramatic, and foreign rights. Payment to the taxpayer, which he contended was long-term capital gain, was a percentage of the retail price of the copies sold. The court holds the payments to be ordinary income, saying: "We do not now decide that a transfer by a citizen of but a part of the bundle (of rights) for a definite sum, or a transfer of the whole for an indeterminate sum, is a sale for purposes of Section 117. We do hold that when, as here, the transfer is both (1) a transfer of a part of the cluster of rights and (2) for an amount wholly indeterminable at the time of the transfer, no such sale occurs." *Cory,* CA-2, 3/9/56.

Capital gain on patents sold though production measured price. In 1946, taxpayer assigned all his rights in two pending patent applications in consideration for payments, apparently measured by sales of the items manufactured pursuant to the patent applications, called "royalties" in the agreement. The applications had been held for more than six months, and taxpayer was not a professional inventor at the time of their sale. The court holds that the transaction resulted in the sale of a capital asset held for more than six months, and the proceeds were taxable as long-term capital gain. *Waterson,* DC Texas, 12/31/55.

Exchange of oil payment for ranch is taxable, but as capital gain. [*Non-acquiescence*] The Code provides that the exchange of property held for productive use or investment solely for property of a like kind is not taxable. Taxpayer exchanged his right to limited overriding royalties of oil payment interests for the fee simple title to real estate. The court said the nature of the rights given up (overriding royalties) was not "like" the nature of the rights acquired (fee simple title) because the limited mineral interest expired when a fixed sum was realized from it. However, the Commissioner erred in treating the gain as ordinary income, subject to depletion. It has been held (*Hawn,* 23 TC 516) that an oil payment is a capital asset. [*Hawn* has just been reversed by CA-5; see page 347. *Ed.*] *Fleming,* 24 TC No. 93, *non-acq.* IRB 1956-15.

Taxpayer was joint venturer, not employee; termination payment capital, not salary. Taxpayer agreed to operate a theatre for 25% of the profits and to share in 25% of any losses. Later the agreement was modified to give taxpayer an additional $35 a week to cover out-of-pocket expenses and also a share in the profits of other theatres which he did not manage. In 1948 the agreement was terminated and taxpayer received $25,000. The court holds the payment was received as consideration for the sale of taxpayer's interest in a joint venture and was taxable as capital gain; it was not to be treated, as the Commissioner had argued, as consideration for the cancellation of an employment contract. *Switow,* TCM 1956-63.

Income from invention treated as sales price. Taxpayer granted an exclusive license to make, use, and sell his invention, together with the right in the licensee to grant sublicenses, but reserved the right to terminate the contract upon failure of the licensee to make the agreed payments. The reservation is held to be a provision governing a contingency that might arise after the sale, which does not render the contract a mere licensing agreement. Amounts received by taxpayer were taxable as capital gains on sale of the invention. *Hudson,* TCM 1956-60.

Distributees have ordinary income on their sale of corporate liquidating dividend. Taxpayers, who had received FHA-insured apartment buildings as a distribution from their corporation (see page 336), carried on an aggressive and active campaign to sell the property by advertising in leading newspapers and by hiring a real-estate broker who was supplied an office, telephone, and office help. The court concluded the apartments were held primarily for the sale to customers in the ordinary course of business, and the gain realized was ordinary income. *Pool,* TCM 1956-64.

Capital gain on sale of rental units. Taxpayer constructed some houses for sale and some for rental. In 1942, 1943, and 1944, it built 1,098 rental units. In 1946, after the removal of price controls on the sale of houses, it decided to liquidate its rental investments. All of its rental property was sold in the years 1947-50, and taxpayer wound up the rental part of its business. Sales were made by taxpayer's own organization to save brokers' commissions. The Tax Court held that once the decision was made to sell the rental property, the houses were held for sale. This court reverses. If all the units were sold to one buyer, the gain would be capital. Though selling piecemeal, it is still merely engaged in liquidation. One dissent: he would uphold the Tax Court theory. The court finds ordinary income on sales of undeveloped land; the property was held for sale in the ordinary course of business. *Curtis Company,* CA-3, 3/30/56.

Jury finds subdivider had ordinary income on sale of lots. Taxpayer bought 239 acres, plotted it as a subdivision and sold some lots. Few facts are given but the jury found the income was ordinary. *Huidsten,* DC N. Dak., 2/11/56.

Payment for patent was capital; had reported as income for 13 years. Taxpayer's father had in 1938 entered into an agreement "licensing" a manufacturer to use his patent throughout the world. Payment was based on production. He reported the royalty as ordinary income. Taxpayer inheriting the patent sued for refund of 1951 tax on the ground the agreement was a sale and proceeds are capital. The court holds the intent was to make a sale and refers to Congressional intent to aid inventors. *Roe,* DC Tex., 1/14/56.

CA-5 finds ordinary income in 19-month transfer of oil payment. Taxpayer assigned a $1 million oil payment which he owned to a contractor who agreed to build a house for him. The oil payment was to revert to the taxpayer after the contractor received a maximum of $120,000. It paid out in 19 months. Taxpayer contended that the assignment resulted in a sale of a capital asset and the Tax Court agreed. This court reverses and holds that the transaction was an assignment of anticipated income which remained taxable to the taxpayer. The interest transferred, though an interest in

real property, was not substantial enough in either amount or duration to warrant the conclusion that there was a sale. The court distinguishes its decision in *Caldwell*, 218 F.2d 567, allowing capital gain on an oil payment assignment, on the ground that there the payout would take nine to thirteen years. The effect of this agreement was the same as if the taxpayer had borrowed the necessary funds and used the oil payment as collateral for the loan, paying off the loan as the oil payments were received. *Hawn*, CA-5, 3/27/56.

Capital gain on sale of oil payments. Taxpayer, an estate, sold an oil royalty in order to pay estate taxes. The sale provided that the purchaser was to receive the royalty payments until $10 million plus interest had been received, after which the royalties reverted to the estate. The interest paid out in three years. Taxpayer claimed that the proceeds of the sale were long-term capital gain and the court agrees. The parties intended a sale, the royalty interests were capital assets, and the amount to which the purchaser was entitled represented a substantial part of the seller's interest. [Cf. *Hawn*, above. *Editor.*] *O'Connor Estate*, DC Tex., 3/27/56.

Floor trader has capital losses in commodities futures. Taxpayer, a partner in a brokerage firm, was a member of the Chicago Board of Trade and as such bought and sold commodity futures for his own account. He was present on the floor carrying on his own trade practically every business day. In 1943, he averaged 41 transactions a day. He sustained about $136,000 net loss in that year. The district court held that the futures were property held for sale to customers and the loss was ordinary. This court reverses. Taxpayer was a trader; he held the contracts for price fluctuations, buying and selling followed; he did not hold for sale. The *Corn Products* case (350 U.S. 46) treated commodity futures as non-capital assets but the taxpayer there was a manufacturer and was engaged in hedging. *Faroll Estate*, CA-7, 3/15/56.

Settlement on government contract did not include tax thereon. [*Certiorari denied.*] Taxpayer, a general contractor, received some $1,600,000 in settlement of a dispute about reimbursable costs arising out of contract changes and speed-up in an airplane plant contract. He argued that the proceeds were not taxable since settlement of taxes were part of the over-all settlement of the contract dispute. The court disagreed. It observed that representatives of the Justice Dept. with whom taxpayer had been dealing had no authority to settle the tax liability and the terms of the settlement did not do so. The court similarly rejected taxpayer's argument that if taxable, the proceeds were taxable as capital gain in exchange for the claim. The nature of the settlement depends on the nature of the claim which was for services and is ordinary income. *Sanders*, CA-10, 8/17/55, *cert. den.* 2/27/56.

DEPRECIATION & DEPLETION

Sale of equipment called off; forfeited payments by "purchaser" reduce basis. Taxpayer purchased a power coal shovel at a total cost of $97,200. The shovel was delivered to another company under an arrangement whereby the latter would pay taxpayer $3,300 a month until the total cost of $97,200 plus 4% interest had been paid, at which time title would pass. After making payments totalling $38,500, the company returned the shovel. The court held taxpayer's investment was reduced by the payments received, and allowed a basis for depreciation of only $58,700. Taxpayer used a 3-year life in computing depreciation on mining equipment because of extra-heavy use. The Commissioner changed this to 7, 10, and 11 years, and since taxpayer failed to show that the extra usage shortened the life of the equipment beyond that determined by the Commissioner, the court sustains the Commissioner. *Kohinoor Coal Co.*, TCM 1956-79.

Clay percentage depletion computed after baking. The court finds that the ordinary treatment processes to bring clay to its first merchantable state include all the steps through forming it into bricks and baking in the kiln. Percentage depletion is therefore computed on the value at that point. *Ferris Brick Co.*, DC Texas, 1/2/56.

Lessee buys fee; cost allocable to building amortizable over its life, not old lease. In 1945 taxpayer bought for about $2 million the land and building which it then held under a lease having 21 years to run. The Tax Court found the value of the land was $660,000; it found the balance was neither expense nor amortizable. The Tax Court disallowed amortization because the taxpayer had itself constructed the building and deducted the entire cost over an earlier lease. The Second Circuit allowed amortization over the remaining useful life of the building. The Supreme Court affirms. The payment is not deductible as the expense of freedom from a burdensome lease. *Millinery Center Building Corp.*, Sp. Ct. 3/26/56.

Refund of co-op charge for capital fund is income. [*Certiorari denied*] Taxpayer, reporting on the cash basis, was a member of an apple growers co-operative marketing association and, as such had paid in five cents a box assessed to build up a revolving capital fund. The payments were made from 1930 to 1937. In 1951, the co-op refunded some of the assessment. The conclusion is stated that the reimbursement represents taxable income. *Moe, cert. den.* 4/4/56.

Strip miner held to have economic interest despite land owner's right to cancel. Taxpayer, a strip miner of coal, sold land to the National Steel Corporation at cost, under an agreement that taxpayer would continue mining operasions for $1.10 per ton produced. The Tax Court held that taxpayer was paid merely for service and that it had no rights in the coal itself. This court, in reversing the Tax Court, holds that taxpayer's understanding with National was that it had the exclusive right to mine all the coal in the land, as shown by its investment of $500,000 in equipment. Its profits were dependent solely upon extraction and delivery of the coal. Therefore, although National had the right to limit the amount of coal to be mined and to terminate the agreement on 90 days' notice, taxpayer had an economic interest in the coal and a right to depletion. *Weirton Ice & Coal Co.*, CA-4, 3/19/56.

Depletion allowed on coal extracted from refuse banks. Taxpayer was the owner of a coal mine in Pennsylvania which it and its predecessors in interest had worked since 1870. In recent years, it started to extract coal from the mine refuse which had accumulated over all those years. The court holds that taxpayer, owning the mine, had an eco-

nomic interest in both the coal in the ground and in the "coal, culm, and refuse banks." It was, therefore, entitled to depletion on the coal it extracted from the accumulated refuse banks. *Turkey Run Fuels, Inc.*, DC Pa., 3/7/56.

NEW DECISIONS INVOLVING ACCOUNTING METHODS

Nursery inventoried crops; this was error it can change. Taxpayer, incorporated in 1947 to grow and sell rose bushes, filed its returns for fiscal years ended in 1948, 1949, and 1950 deferring the cost of growing crops. In 1951 it filed amended returns charging off costs as they were incurred, claiming that the prior method was inventorying growing crops, a practice forbidden by regulation. The Government claimed this was merely the legitimate crop-cost method. In these years the result would be the same. Noting that taxpayer stated on the return that inventories were at the lower of cost of market, the court finds that taxpayer did use inventories and since that was wrong it can file amended returns. *Amling-DeVor Nurseries*, DC Calif., 2/28/56.

Can't amortize, as discount, excess of bonds over basis of property received tax-free. In a nontaxable reorganization, taxpayer issued to a gas company bonds having a face value of about $10 million in exchange for properties that had an adjusted basis of about $7 million. Taxpayer contended that as it is required in a nontaxable exchange to use as its basis the adjusted basis in the hands of the transferor, it is entitled to amortize the difference between its total liability on the bonds and the adjusted basis of the property it received as bond discount. The court holds that failure to establish the fair market value of the property at the time of the transfer precludes the right to the deduction. As to taxpayer's contention that this decision would result in the holder of the bonds paying a tax on $3,545,355.56 when it realizes the face amount of the bonds while the taxpayer could never recover more than the basis of the property through depreciation or a subsequent sale, the court states: "It is well settled that a taxpayer is free to adopt such organization for his affairs as he may choose but having done so, he must accept the tax consequence of his choice; this is so whether he contemplates such consequence or not." Furthermore, the court points out that the history of the Treasury regulations permitting the bond discount amortization indicates that it is applicable to bonds issued for cash, not to bonds issued for property. Moreover, the Regulations would not apply here; this was not an arm's-length transaction; the same parent owned both corporations. *Montana Power Co.*, CA-3, 3/28/56.

Can't switch to completed contract after reporting on accrual basis. Taxpayers were members of a joint venture constructing a Japanese relocation center under government contract. The partnership return for 1942 reported income on an accrual basis. Amended returns for 1942 and 1943 were filed in 1947 showing no income for 1942 and reporting all the income from the contract in 1943, the year in which it was completed. Taxpayers argued that the 1942 accrual-basis return was wrong because the joint venture accounted for its income on the completed-contract method, and they then had the mistaken belief the contract was completed in 1942. The court holds that the accrual method was intentionally adopted and was binding; taxpayers could not have had any doubts that the contract was not completed in 1942. *Daley*, DC Calif., 2/29/56.

Reserve for future expenses allowed; Tax Court reversed on "claim-of-right" doctrine. Taxpayer sold gas furnaces for $20 or $25 more than competitors because he guaranteed to turn them on and off each year for five years. Each call would cost $2. Taxpayer deducted $20 at the time of sale as a reserve for this future expense. The Tax Court disallowed it; it had received the sales price under claim of right and it had not yet incurred the expenses. This court reverses; taxpayer's method reflected its income properly. The court says its decision is in accord with *Harrold* (4th Cir., 192 F. 2d 1002) allowing estimated cost of back filling, and *Pacific Grape Products* (9th Cir., 219 F. 2d 862) allowing estimated cost of labeling and shipping goods sold. It refers with approval to the criticism in *Beacon Publishing Co.* (10th Cir., 218 F. 2d 697) of the claim-of-right doctrine as applied by the Tax Court as putting taxpayers practically on a cash basis whenever the receipt and the related expense fall in different years. *Schuessler*, CA-5, 3/14/56.

Subcontractor must accrue actual billings as income. An accrual-basis subcontractor working on a construction job billed the prime contractor as work progressed in accordance with their mutual understanding. Six weeks after work was begun taxpayer's fiscal year ended. That year's return included in income monthly billings based on costs plus 10% for overhead and 10% for profit. The job was completed in the following fiscal year, during which the remainder of the $62,000 contract price was billed. On the job as a whole, gross profit was not the 20% of $62,000 ($12,400) on which the first billing had been made but some $26,000. Taxpayer filed an amended return for his first year increasing the profit for that year on the theory that the true profit was earned ratably as costs were incurred. Taxpayer argued that only this way could it clearly reflect income. However, the court holds that the proper income to be accrued is the amount of the billing; that is all it was entitled to then. *Capital Engineering Co., Inc.*, 25 TC No. 151.

Cost of cattle sold is deductible in year of sale. Taxpayer, a cash-basis cattle feeder, had followed the practice of deducting the cost of cattle purchased whether or not they were sold in that year. The Commissioner required him to defer the deduction of this cost until the year of sale. The court agrees. Acceptance of incorrect returns in an earlier year did not estop the Commissioner from challenging the correctness of items similarly reported in a later year. *Shore Estate*, TCM 1956-75.

Cash-basis taxpayer doesn't realize gain on "receipt and option" sale until cash is received. A decedent who had been reporting on the cash basis sold some farm property in 1947 under a "receipt and option." The court treats the transaction as a sale, though some Colorado courts regard such documents as mere options. The document called for a down payment and annual installments over succeeding years until the full purchase price with interest was paid. The contractual obligations were held not amounts realized in 1947. The Code defines amount realized on a sale as cash plus fair market value of other property. However, the "receipt and option" is in no sense a note, mortgage, or other obligation of the buyer such as would be income, even though the taxpayer is on a cash basis. It is a mere schedule of

payments, in effect an account receivable. It has no value. Since the payments were not in excess of his basis for the property sold, he realized no gain on the sale in 1947. *Hurlburt Estate,* 25 TC No. 152.

Unauthorized change in accounting method requires "throwback" adjustment. Taxpayer had been reporting sales on a cash basis under a hybrid method. In 1949 he changed voluntarily to a strict accrual method without the consent of the Commissioner. The court upholds the Commissioner's contention that taxpayer should have included in his 1949 income the amount of $13,800 which was the opening accounts receivable. Taxpayer argued that his prior method was wrong; he did not change his method, he merely began to file proper returns, and since each year is examined and assessed separately, errors in closed years cannot be corrected. The Tax Court said that taxpayer's prior method was not necessarily incorrect. Consistently applied, it would produce a result not greatly different from that produced by a strict accrual method. Therefore taxpayer should have requested consent, and cannot be allowed to fare better than if he had, and the Commissioner had, as he certainly would, required this correction. *Goodrich,* 25 TC No. 143.

Change in crediting income is a change in accounting method. Taxpayer, on the accrual basis, sold Philippine copra under a standard copra sales contract which provided that the purchaser pay 95% of the invoiced price before delivery based on shipped weight, with a final settlement at the time of unloading and weighing of the shipment. It had been accruing the entire invoice amount of such contracts in the year of the contract. In 1949 taxpayer adopted a new system of including in gross income only 95% of the invoice amount of its year-end contracts under which landed weights had not been determined prior to December 31st. The new system is held to represent a change in accounting method which required the Commissioner's prior consent; it is not merely a technical correction of prior errors. *Pacific Vegetable Oil Corp.,* 26 TC No. 1.

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DEDUCTIBILITY

Rental paid to mother considered excessive. Taxpayer opened one of the three retail liquor stores in his community authorized after a wet victory. To begin business he leased a store from his mother for an annual rental equal to 5% of total gross retail sales, with a minimum guarantee of $200 per month. The premises had been previously rented for $125 a month. The court disallowed as excessive annual rental payment in excess of $3,600. Taxpayer and the other two store operators were obviously going to make substantial profits. Though percentage leases like this were not uncommon in the area, the total rent produced was far in excess of reasonable and, the court believes, would not have been paid except to relatives. *Wender,* TCM 1956-81.

Another licensee in the same town leased a store from his father under the same terms. Same result. *Davis,* 26 TC No. 4.

First-year rentals on government mineral leases deductible. Taxpayers obtained oil and gas leases from the United States for the exploration and development of oil and gas. In connection with these leases, the taxpayers had to pay filing fees and first-year lease rents, which the Commissioner contended had to be capitalized. The court holds that the fees and rents are deductible as ordinary and necessary expenses because they were paid for the use of property to which the taxpayers were not taking title and in which they had no equity. *Hagood,* DC Wyo., 1/9/56.

Insurance broker can deduct cost of errors he absorbed. [*Acquiescence*] Taxpayer absorbed the cost of correcting errors when he made mistakes in advising customers of the cost of policies. This is an ordinary and necessary expense. *Boyle, Flagg & Seaman, Inc.,* 25 TC No. 8, *acq.* IRB 1956-15.

Liquor store owner can't deduct electioneering expenses in local option campaign. Dues paid by taxpayer, a liquor-store owner, to his association in order to defray the cost of an election campaign to persuade voters to vote "wet" in a liquor referendum are held not deductible as ordinary and necessary business expenses. One half of taxpayer's country club dues was allowed as a business expense, the evidence established that neither taxpayer nor his family made use of the club's golf course or swimming pool. *Davis,* 26 TC No. 4.

Builder can expense or capitalize commitment fees for constructions funds not drawn down. Commitment fees or standby charges (usually at 1% or less per annum) paid by a taxpayer pursuant to a bond sale agreement, the proceeds of which can be drawn down by the taxpayer when needed for construction purposes, are in the nature of a carrying charge and may be deductible as a business expense or capitalized as part of construction costs. *Rev. Rul.* 56-136.

Delaware realty taxes accrued on lien date (old law). [*Acquiescence*] Delaware ad valorem taxes on real estate for 1949 accrued and became payable on July 1st when they became a lien on the property. A taxpayer who acquired the property on May 2nd of that year and paid the tax could take the full deduction. [Under 1954 Code the deduction for taxes on real estate must be apportioned between seller and purchaser in year of sale. Ed.] *Keil Properties, Inc.,* 24 TC No. 123, *acq.* IRB 1956-15.

Delaware real property taxes accrue on

due date. In Delaware, ad valorem taxes on real estate accrue on their due date when liens attach to the property. For taxable years under the 1939 Code, only the owner of the property at such time is entitled to the tax deduction. [Under the 1954 Code, when property is sold tax may be apportioned between buyer and seller. *Ed.*] *Rev. Rul.* 56-145.

Loss deductible when shipper's partial reimbursement is fixed. In 1947 taxpayer's furniture was shipped from Germany to Maryland by the Army and he filed a claim with the Army for loss due to alleged theft and damage. Part of this claim was allowed in 1948. In 1949 the taxpayer took a deduction for the rest. The Tax Court held the loss occurred in 1947 and its extent was determined in 1948. No deduction was allowable for 1949. This court affirms. *Leet,* CA-6, 2/18/56.

Contributions to unemployment benefit plan are deductible. Irrevocable contributions made by an employer into a trust fund, pursuant to an agreement with the union which provides for the payment of supplemental unemployment benefits to the employees, are deductible as an ordinary and necessary business expense. *Rev. Rul.* 56-102.

Payments on insurance company's certificates are "interest." Amounts paid by a mutual insurance company to the holders of certificates of indebtedness are "interest paid" on indebtedness and not dividends. Under the facts the certificate holders and the company are in a debtor-creditor relationship. *Rev. Rul.* 56-107.

Full real-estate taxes accrue in 11-day year of dissolution; are loss carryback (old law). Social Research Foundation, Inc., an exempt foundation, held all the outstanding stock of the taxpayer, which owned and operated four office buildings. Taxpayer dissolved on 1/11/50, transferring all its assets to the foundation. On its final return for the period 1/1–1/11/50, it deducted real-estate taxes which had accrued on 1/1, with the result that a loss was sustained for the period. This loss was carried back to 1949 as a net operating loss and a refund claim was filed. The Commissioner, under 1939 Code Section 45, contended that to properly reflect income these taxes must be allocated between taxpayer and the foundation. The court

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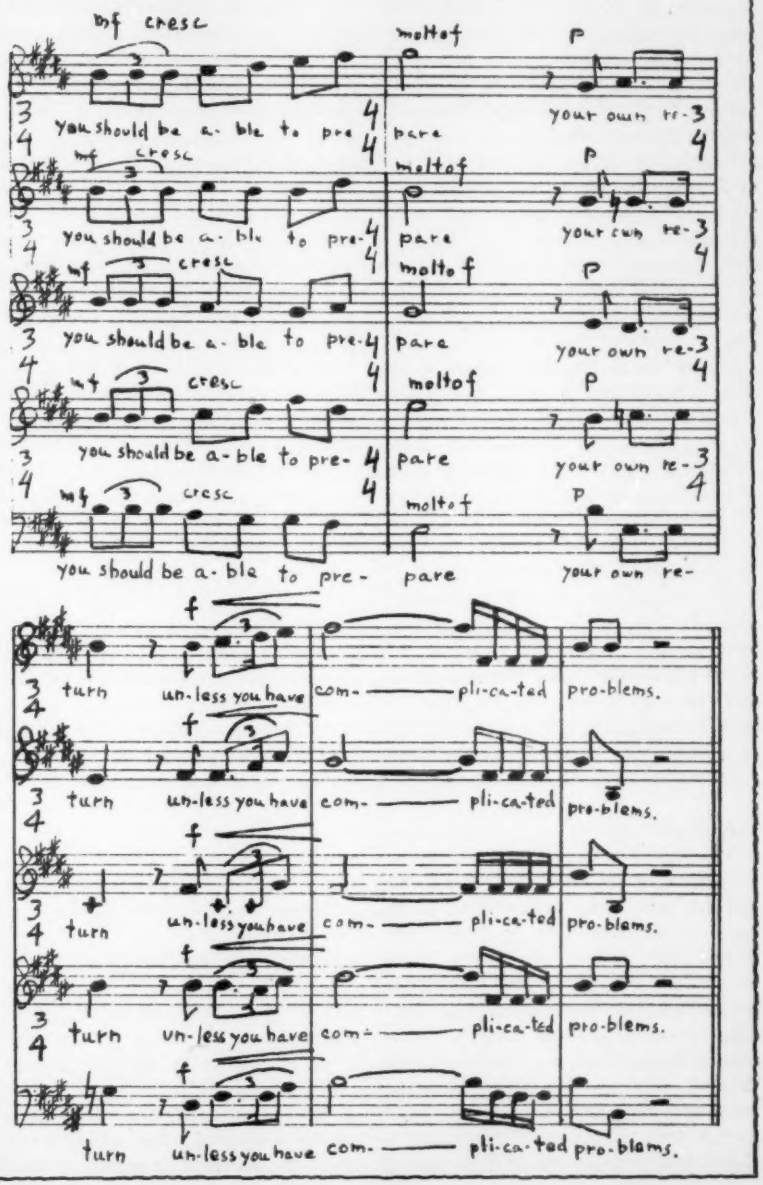

finds that taxpayer was entitled to deduct the taxes in the year in which they accrued and the resulting net operation operating loss carryback was valid. Section 45 cannot be applied to a valid and bona fide transaction, such as this was. [Under Section 164 of the 1954 Revenue Code, real-estate taxes must be apportioned between the seller and the buyer on the basis of the number of days each owned the property. *Ed.*] *Simon J. Murphy Co.*, CA-6, 4/2/56.

Cost of proxy and option must be apportioned to allow deduction for amount attributable to proxy. Taxpayer paid $50,000 to another stockholder for the right to acquire the latter's stock upon his death, and also to vote that stock during the owner's lifetime. Taxpayer owned 15% and was trying to prevent a proposed merger. Taxpayer claimed the entitre cost as a non-business deduction, but the court holds that the option was a capital asset. Failure to submit evidence apportioning the price between the proxy and the option precludes taxpayer from claiming any part of its cost as a deduction. *Lawrence*, DC RI, 3/16/56.

Payment to partnership upon withdrawal held capital expenditure. The taxpayer was a member of a partnership in the reinsurance business. He withdrew from it. The value of the business he took with him was computed at 150% of their annual commissions. This amounted to $61,000 which he paid the partnership. He claimed the $61,000 as a deduction. The court denies the deduction either as an ordinary business expense or as a loss in a transaction entered into for profit. The payment was made to enable the taxpayer to pursue the reinsurance business on his own and must be treated as a capital expenditure. *Balis*, Ct. Cls. 4/3/56.

Can't deduct interest on loans from wife repayable when convenient. Taxpayer, a surgeon, deducted interest paid to his wife on money she advanced him to start in practice, buy a home, etc. Though the district court allowed the deduction this court reverses. The loans were not due on a definite determinable date but only when it could be done without jeopardizing the family finances; they were not true debts; interest is not allowable. *Virgin*, CA-5, 3/16/56.

Can't deduct unproved cost; no record of overceiling payments. Taxpayer purchased merchandise above OPA ceiling prices and deducted the excess as cost of goods sold, though he destroyed all checks and invoices. The court upholds the Commissioner's disallowance because the taxpayer did not meet the burden of proving the payments. An affidavit of the recipient of the payments was not sufficient because it merely stated a conclusion and gave no details. *Schwarz*, DC Wisc., 3/2/56.

Legal fee for contesting tax assessment deductible; fraud indictment came after services ended. Taxpayer paid legal fees in 1950 in connection with an examination of prior years returns begun in 1949. These attorneys ceased to represent him in 1951 when he was indicted for criminal evasion. He pleaded nolo contendere and was found guilty; taxpayer did not claim deduction of the fee to the lawyer representing him in criminal case. The Commissioners disallowed the fees to the first lawyers on the ground they were attempting to prevent the fraud action; he pointed out that from the beginning a special agent was in on the investigation and that fraud penalties and criminal action were discussed. This court sustains the Tax Court and finds that the civil aspects were predominant; therefore the deduction was proper. One dissent on the ground that the facts show the services were mainly an attempt to forestall indictment. *Schwartz*, CA-5, 3/14/56.

OTHER DECISIONS

Stockholders fearing liability for faulty organization pay corporate debts; they are non-business. Taxpayers owned all the stock of a restaurant corporation which failed. They had failed to obtain a California permit to issue stock and so were liable for the corporate debts, which they paid. The court finds they were not in the business of financing restaurants nor was the venture one entered into for profit. The debt is non-business. *Idol*, DC Calif., 2/7/56.

Jury finds business loss in stockholders' advances to corporation. Taxpayer, who was president of several corporations, made advances to one of them which became worthless. It appears from the charge that taxpayer spent a good deal of time in connection with the business of the corporation to which he had made the advances. In answer to specific interrogation, the jury found that the advances were made as part of a business regularly carried on by the lender, and the loss was not incurred as a result of a bad debt. *Pool Estate*, DC Pa., 1/17/56.

Purchaser's promise to pay is not income; cannot readily be valued. [*Nonacquiescence*] Decedent and his wife reported income on a cash basis. In 1945 they contracted to sell a saloon which they owned jointly. The purchasers agreed to make a down payment and monthly payments thereafter, title to be transferred on completion of payments. No note, mortgage, or other evidence of indebtedness was given. The down payment and monthly cash payments received in 1945 amounted to less than the adjusted basis of the property. The Commissioner had valued the purchaser's promise to pay at 100% of its face value. The Tax Court, in *Nina J. Ennis*, 17 TC 465, concerning the decedent's wife, had held that the unsecured promise was not equivalent to a mortgage and, not being negotiable, not an amount realized on the sale. In assessing the deficiency against the decedent the Commissioner argued that the land contract was readily negotiable and valued the purchaser's promise at 75% of face. The Tax Court held that the mere promise to make future payments had no ascertainable market value in 1945. However, the Tax Court did admit that such saleable contracts may ordinarily be valued but this one could not because (1) an annual liquor license, perhaps difficult to renew, was required to operate the property, and (2) the unpaid balance was exceptionally large. *Ennis Estate*, 23 TC 799, *non-acq.* IRB 1956-11.

Donor of remainder has income when donee pays mortgage on retained life interest. In 1947, taxpayer entered into an agreement with Southwestern University of Memphis, Tennessee, by which (1) he said he intended to acquire a residence and contribute it to the University, subject to the life use of himself and his wife, (2) he reserved the right to mortgage the property up to its purchase price, but would deed the property to the University without any liability on its part, (3) he stated he expected to make cash contributions to the University, which the latter could use to pay off the mortgage. In 1947 the Commissioner issued a ruling based on this

agreement, holding that he would have allowable deductions for the present value of the remainder interest in the property, and for contributions made to the University which it might use to discharge the mortgage indebtedness. The taxpayer in 1948 purchased property at cost of about $99,000, and mortgaged it for the full purchase price. Prior to its conveyance to the University taxpayer contributed $75,500 cash, which the University, also prior to the conveyance, used to pay off part of the mortgage. On January 10, 1949, taxpayer conveyed the porperty to the University, subject to the life estates and the liens of the mortgage. In April, 1949, he made a cash contribution of about $24,000, and on the same day the University paid off the balance of the mortgage for the same amount. The Internal Revenue Service did not question the contributions made by the taxpayer. However, it contended that the taxpayer had income of $24,000 in 1949, because the University paid off the mortgage for which taxpayer was personally liable. The court holds that when property is received subject to a mortgage, the rule is that the transferor, if called upon to pay the indebtedness, can look to the property in the hands of the transferee for reimbursement. It follows, therefore, taxpayer did not realize income to the extent that the payment by the University was attributable to its interest. Taxpayer did realize income, however, to the extent that the $24,000 payment was attributable to the life estates which, on the facts, was about 60%. *Herff,* DC Tenn., 2/23/56.

Gambler's gross income is his net of winning and losing bets in a particular race. Taxpayer was convicted of wilfully failing to file a tax return when he had gross income in excess of $600. The district court, in charging the jury, had instructed that the government had only to prove that taxpayer, a bookmaker, had received income from winning bets in excess of $600. On appeal the court reverses, finding that a professional bookmaker's gross income consists only of the excess of winning bets over losing bets on a particular race. The court drew an analogy between a professional gambler's losses and the merchant's cost of goods sold. One dissent. *Winkler,* CA-1, 3/8/56.

Filipino hospital trainees taxable on remuneration. Stipends received from hospitals by Filipino nationals entering this country under the Information and Educational Exchange Act to train and study at approved hospitals are taxable. The trainees claimed the stipends were gifts to enable them to serve their country. However, the trainee is taxable because he performs services which are of material benefit and receives substantially the same amount as is paid to citizen performing similar services. *Rev. Rul.* 56-101.

Mortgage prepayment penalty taxable as interest. Penalty payments received by taxpayer from mortgagers upon prepayment of their mortgage indebtedness is taxable interest income. The charges were, in fact, a part of the cost to the borrowers for the use of taxpayer's money. *General American Life Insurance Co.,* 25 TC No. 149.

Gambling losses can be offset against other winnings. Taxpayer won $9,000 in a gambling pool. Wagering losses of $2,400 sustained later in the same year on other pools were held a proper deduction from his gross income. The Tax Court allows the loss as a deduction from gross income. *Drews,* 25 TC No. 161.

Employee "lent" to Ethiopia not paid by U.S.; pay is exempt. Taxpayer was hired and paid by the United States Department of Commerce and was lent to the Ethiopian government for service in Ethiopia. His pay came out of a fund set up by Ethiopia from its loan borrowed from the International Bank. The Commissioner contended that the taxpayer was paid by the United States or an agency thereof, but the court holds that the taxpayer was really paid by the Government of Ethiopia, despite the mechanics of the payment by the United States. The salary therefore was exempt from U.S. taxation. *Kirchbaum,* DC Tenn., 2/16/56.

Panamanian social-security benefits not taxable. U.S. citizens living and working in Panama need not include Panamanian social-security benefits in their taxable earnings. They are similar to U.S. benefits, which are tax-free. *Rev. Rul.* 56-135.

Ordinary income on settlement of suit for loss of profits. Taxpayer received $5,000 in settlement of an action against its former officers and directors for conspiring to destroy its business. The court holds the amount taxable as ordinary income because the taxpayer failed to meet the burden of proving that any portion of the recovery was attributable to goodwill, a capital asset. The evidence indicates that the settlement was for lost profits and a mere allegation in the original complaint of injury to goodwill was not sufficient evidence, in itself, that any part of the recovery was for such damages. *Phoenix Coal Co. Inc.* CA-2, 3/13/56.

Car won at drawing held a gift (old law). Taxpayer won a car at a ticket drawing held at a baseball game. The court holds the receipt of the car is a gift and not taxable income. Taxpayer was an avid baseball fan and attended practically all the home games. He had gone to the game as a fan and not in expectation of winning a car. [Under the 1954 Code, prizes other than achievement awards are taxable income. *Ed.*] *Fernandez,* DC Fla., 3/15/56.

Wife taxable on proceeds of sale of patent after assignment of sale contract to her. [*Non-acquiescence*] Taxpayer sold a patent for payments during the life of the patent. Six years later he assigned this contract to his wife. The court holds the wife taxable on subsequent payments. The assignment was not an anticipatory assignment of income but a real gift of property. *Reece,* 24 TC 187, *non-acq.* IRB 1956-15.

Contingent legal fees taxable when received though later repaid. Legal fees received by a lawyer in 1949 under a contingent-fee contract are held taxable when received, even though it developed that the lower state court decree in 1948, which led to the payment of such fees, was reversed late in 1949 by the highest court of the state. *Rosenberg,* TCM 1956-68.

Farmer constructively receives proceeds despite agreed deferred payment for grain. Taxpayer sold grain in October, 1947, payment to be made in January, 1948. On the first trial the district court directed the jury that payment was not constructively received in 1947. CA-8 reversed and remanded for a new trial on the ground that this instruction was improper. On the second trial the jury holds taxpayer had constructively received the proceeds in 1947. *Banek,* DC S. Dak., 10/19/55.

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Inherent prejudice against taxpayer in net-worth cases can rarely be overcome

by THOMAS W. HILL, JR.

The four recent Supreme Court cases on the net-worth method have provided fertile ground for the growth of theories, objections, and new interpretations of the net-worth method of proving taxpayer received unreported income. One fact remains, this author finds: the net-worth method has certain built-in infringements on the constitutional rights of the defendant; the method requires, if maximum precautions against self-incrimination are to be taken, some very forehanded, awkward, and suspicious maneuvers on the part of taxpayer and his advisors. Similarly, taxpayer's counsel must fight every inch of the way on admission of evidence. No good way appears to prevent juries drawing improper inferences, no matter how strong or just the charge by the judge. These problems, discussed by Mr. Hill in the following excerpts from a paper written by him for 41 CORNELL L.R. 108, *leaves us with a wholesome respect for the traps facing both sides in the net-worth prosecution. Mr. Hill's original paper is fully annotated; our purpose here being to inform briefly, we have omitted most footnotes.*

THERE IS NOTHING COMPLEX in the theory which underlies a prosecution where unreported taxable net income is computed based on increases in net worth. The application of the theory rests on the premise that if the government can prove how much a taxpayer was worth at the beginning of the tax period and how much he is worth at the end, and if, after striking a difference and adding back nondeductible living expenses, the total exceeds the net income reported for income-tax purposes plus any reported or known nontaxable receipts, the excess, if any, represents unreported taxable net income.

The use of the words "net worth" is misleading. The computation of unreported income when the "net worth" method is used is not in the least concerned with "value"; it is concerned only with the *cost* of assets acquired and the actual amount of expenditures, since the purpose of the method is to show income available for disbursement. The "value" of the assets acquired is immaterial. If assets purchased in a prior year are still on hand at the end of a tax year, any increase or decrease in value would be immaterial in showing either "money spent" or realized profit or loss.

The net worth method of determining income has long been recognized in computing deficiencies and assessing fraud penalties for civil purposes where the Commissioner has the burden of proof in connection with the justification of the fraud penalty even though his determination of unreported income is presumptively correct.

Under Section 145(b) (new Code Section 7201) there are two elements in a prosecution for attempted income-tax evasion. The government is required to prove that a tax was due for a particular year and that the failure on the part of the defendant to disclose this fact represented a wilful attempt to evade the tax.

As a practical matter, the wilfuness element in net worth cases is inseparable from the proof which the inference of unreported net income is to be drawn. The pattern of the net worth cases generally shows large expenditures of cash over a considerable period of time, a failure to maintain records, and a taxpayer engaged in a business, sometimes illegal, where cash receipts are the rule rather than the exception.

It is probably true that when the indirect methods of establishing unreported income were first developed, they were used only in cases involving substantial understatements of income. There is no reasonable basis for concluding that the size of an alleged understatement of net income establishes a criterion for the application of the net worth determination. Similarly there is no basis for concluding that the method may only be employed in so-called "racketeer cases" or groups considered otherwise undesirable.

Until the recent decisions in the Supreme Court, it was thought that Section 41 of the 1939 Code required the government, before it could employ the net worth theory, to establish that a defendant's books and records were inadequate. The cases were not clear as to how this inadequacy was to be developed or in what respects the books and records had to be found inadequate. At least one court had rejected the "bootstraps" method which permitted the government to establish the inadequacy of books and records by means of the net worth calculation and then prove the unreported income by the same method. Now there can no longer be an objection to a determination of net income by the net worth theory even though a defendant maintains books and records and such records are in agreement with his tax returns for the indictment years.

Proof: The starting point

The validity of the sought inference in the net worth calculation—that the unexplained difference between a defendant's net worth at the beginning of the year and the end of the year, plus his nondeductible expenditures less the

total of reported net income and nontaxable resources is unreported net income—rests on the validity of the net worth at the beginning of the tax year. For the beginning net worth to be adequately established, it must appear that no sources of funds other than those alleged to have been established by the government were available to the defendant between the date on which the government alleges it has first fixed a defendant's net worth and the beginning of the tax year for which the required inference is to be drawn. The problems in connection with such a showing, both for the government and for a defendant, are manifold.

In most cases it is necessary for the government to fix a defendant's net worth at a point in time prior to the first tax year involved in the indictment. The reason for this is the fact that individuals, unlike corporations, rarely if ever set up a "balance-sheet" which becomes available to the government. Consequently, the government must cast around for some fortuitous circumstance in connection with which a defendant has stated his net worth. If this cannot be found the government must begin at the beginning of a taxpayer's economic life.

Where a taxpayer has been of working age for a number of years before the first year for which an indictment has been returned, and no interim net worth has been fixed, it becomes necessary to build up a net worth over those productive years to the beginning of the tax year. The longer the period of time, the more difficult become the problems of the government. Of course, the economic situation as it prevailed through the 1930's has in and of itself provided some assistance. The difficulty of accumulating assets during that period is common knowledge. The courts have indicated that they will recognize the converse where the working lifetime begins in the late 1930's and the early 1940's.

Corroboration of admissions

In most prosecutions brought by the government, this detailed build-up is necessary only to corroborate statements made by the defendant or his representative to the Internal Revenue Service. In many cases the government is aided by the fact that a defendant has, before realizing what he was doing, and before his tax advisers realize what they are doing, given a statement to either a Revenue Agent or to a Special Agent. The result of the statement is to fix the defendant's net worth either at the beginning of the tax year for which he is under indictment, or for the beginning of a year not too distant from the tax year in connection with which he finds himself under indictment. It is not necessary that the statement be in the form of a written schedule of assets and liabilities. A mere oral statement will suffice.

Once this statement has been made, it provides the government with a reference point. In many cases, the statement of the defendant has demonstrated that the increases in net worth during the tax years had to be from unreported income. In others, the statements made have been so out of touch with the realities of the defendant's economic situation that they have served to corroborate, in the eyes of the jury, the evidence offered by the government to fix the defendant's net worth.

The character of these statements as admissions has been the subject of a detailed analysis in the recent Supreme Court cases. Basically, the conclusion is that they are admissions and will not serve in and of themselves to fix the beginning net worth. However, their mere existence means that the government has not far to go by way of corroborating the statement made by a defendant therein. The Court stated that it was not necessary to establish the validity of the figures in the statement, but that proof of unreported income during the tax year will serve to corroborate admissions contained in the statements. This may well mean that the government need not go back of the net-worth statement itself but need only show items of unreported income during the indictment years. If this is the fact, then the Supreme Court's requirement of corroboration is far more apparent than real.

Can admissions be suppressed?

Little success has attended the attempts of defendants to suppress the use of net worth statements and other admissions as to their beginning net worth made prior to trial. These efforts have largely centered on allegations that the statements were given upon representations that no prosecution would result, or at least that the statements would not be used in connection with prosecution. The factual background of each case in which pre-trial motions to suppress have been denied bear careful study by counsel both before and during trial. These motions may and should be renewed on the trial since the denial before trial will probably not be held to be the law of the case.

While a court will not ordinarily upset a prior decision in the same case, a hearing on the issues raised by allegations of unlawful search and seizure or deprivation of the privilege against self-incrimination may be ordered upon a showing of further facts at any time before trial or during the trial itself.

Further efforts to suppress the statements secured have centered not so much on the representations made to the defendant by the employees of the Internal Revenue Service, but rather have focused on their identity. The fact that investigations are often made by Revenue Agents and Special Agents on a joint basis is well known. That is to say, the Internal Revenue Agent is charged largely with the contact with the taxpayer, while the Special Agent is concerned with the actual investigative work which consists of running down leads and requires no contact with the taxpayer. Where statements have been secured from the taxpayer or his representative by a Revenue Agent working in conjunction with a Special Agent, efforts have been made to suppress whatever information is secured by the Revenue Agent on the ground that he misrepresented the purpose for which the information was to be secured by not revealing that he was conducting a joint investigation with the Special Agent. The authorities would seem to indicate that such a situation will not provide the ground for granting a motion to suppress. [See 3 JTAX 251. *Ed.*] The courts may well have in mind the practicalities of the investigation of income-tax cases. The organization of the Internal Revenue Service should not be upset by a decision which requires either that a Special Agent notify a taxpayer that he has undertaken an investigation to determine whether there is a possibility of a criminal charge, or that the Revenue Agent notify the taxpayer that he is working for a Special Agent for the same purpose. To do so would hamper inordinately the criminal aspects of the work of the Internal Revenue Service and would impose a burden on the criminal work of the Service not imposed upon other investigative agencies.

The use of a Revenue Agent in connection with a Special Agent to work on a criminal investigation is no worse than

the use of a "special employee" or "informer." As long as there is no question of entrapment it would not appear that such a practice is in and of itself bad. Certainly a taxpayer or his representative is placed on notice when the government first requires an inspection of his books that if a criminal prosecution is indicated or warranted it will be forthcoming. A taxpayer should not be permitted to estop the government merely because the agent thought when he entered the premises that a criminal prosecution might be developed. To rest these determinations on the state of mind of an individual investigator will hardly prove practical.

This is not to say, however, that where responsible representations are made that no prosecution will result or an actual illegal entry has been effected, the Government should not be prevented from using admissions so obtained. The burden of determining whether or not to assert a claim of privilege must rest primarily on the taxpayer. Assertion of the privilege, if it is to be made effectively, must be made when a taxpayer first becomes aware that his affairs are being subjected to scrutiny by the government. The decision is not an easy one. Any effort to prevent or thwart a legitimate exercise of the judgment applied to that decision should be condemned by the courts.

Kind of circumstantial evidence used

Lacking admission on the part of a defendant of his opening net worth, evidence must be offered by the government to establish that figure. And in a great majority of cases, evidence will in all probability also be offered even where there are admissions as to opening net worth.

Pehaps the opening gambit in all cases is the offer on the part of the Government of a defendant's federal tax returns from the beginning of his employment life. In some cases these returns will be available from the files of the Internal Revenue Service itself. In others, they will have been furnished by the defendant, and in still others they will have been secured by the government from a defendant's accountant. The returns are generally offered to show that a defendant would have been unable to accumulate large sums of money during the period prior to the first of a series of tax years in which it is claimed by the government that there had been substantial understatements of net income. The very lack of tax returns may also be offered on this same issue. It is probable that state income-tax returns are admissible over a claim of privilege. A defendant is in an extremely awkward position in a jury trial where he claims large accumulations from income in years prior to the tax years when it can be established from his own tax returns that he did not have such income.

Evidence has also been received to the effect that a defendant worked at menial jobs and his wife was forced to work, that he accumulated debts, and that he went through bankruptcy. All this evidence is designed to show that a defendant had no greater opening net worth than the government attributes to him.

Evidence government can use

Because of the nature of the evidence and because it is circumstantial in nature, virtually no limitation has been placed on the evidence which may be offered by the government. So long as there is any rational connection with income or the lack of income, the evidence has been received. By its very nature, the evidence is of a highly prejudicial nature to a defendant. It is doubtful that the most careful charge on the part of the Trial Court operates to remove much of the prejudice.

About the only evidence which the government is prohibited from using is the net-worth statement contained in a defendant's draft questionnaire. These questionnaires have been held to be confidential in nature and privileged to the defendant. Unless he waives that privilege, his questionnaire may not be admitted into evidence against him. While the decision is undoubtedly sound, a defendant would probably be better off to have his draft questionnaire received against him than he would be to have the multitude of evidence of the type outlined here. The weight of the latter type of evidence offered over a period of days and even weeks is far more impressive than a one-page questionnaire which may have a rational explanation.

The sufficiency of the evidence on the proof of an opening net-worth figure is largely a question for the court. The evidence takes the form of direct testimony about the manner in which the defendant lived and spent money in the years prior to the tax years. If this evidence can be pieced together so as to create a relatively complete picture of the defendant's financial history, the evidence must be held sufficient to submit to the jury.

Must the government negate other sources?

This picture, however, must be a complete one. A mere showing of lack of earnings should not be enough, in and of itself, to send the case to the jury unless some effort has been made by the government to negate the possibility of non-taxable receipts during the period prior to the tax year. These receipts may take the form of gifts, inheritances, and the repayment of loans; account must also be taken of the nontaxable portion of capital gains, reported and unreported, and of depreciation.

There may, in fact, have been unreported taxable income in the earlier years. These possibilities are perhaps remote. The degree of remoteness depends largely on the identity of a particular defendant. The fact that as to a particular taxpayer these possibilities may be remote should not permit the government to discontinue its investigation without making some inquiry.

A rule that the government should be required to investigate the possibilities of such resources is not without reason. It should not be incumbent upon a taxpayer, in order to force the government to make a complete investigation, to give the government leads. The Supreme Court would appear to have indicated that if the government receives no leads directly from the defendant or from his representatives, then it need not conduct an investigation with respect to possible non-taxable resources. If this is taken as somethihng more than dictum, then defendants have been deprived, as a practical matter, of their right to claim their constitutional privilege when they are for the first time subjected to examination by the Internal Revenue Service. Failure on their part to furnish leads may permit the Service to conclude its investigation. The necessity of furnishing leads to prevent a criminal prosecution recommendation places a taxpayer prior to indictment in a position of having to waive his constitutional privilege although he may be well aware of its existence.

It would not appear that the Supreme Court would intend its opinion to be so applied. The test of the sufficiency of the examination conducted by the Government and so the test of the sufficiency of the defendant's opening net worth will probably continue to be phrased in

the language used by the Tenth Circuit in *Holland* [209 F.2d 516, 519 (1954)]: "The government is not required to go beyond records reasonably available in order to foreclose any permissible inference that the unexplained excess expenditures in any taxable year were derived from sources other than current income."

Whether or not records were "reasonably available" to the government should not be made to depend upon whether their existence was made known by the defendant. To place him in such a position is, in effect, telling him that unless he provides the Service with all the information requested, whatever evidence is found against him will be sufficient to ground a criminal charge, if it discloses any deficiency in income tax.

Reasonable interpretation of this language in subsequent cases may be anticipated to test the availability of records to the government by the circumstances of a particular investigation. What the trial court believes the government could have done by way of continuing a particular investigation will control. This is not an entirely satisfactory standard, resting as it does on the discretion of the trial court without a statement of the qualitative or quantitative standards to be applied. In a case decided since *Holland*, the Fifth Circuit held that where the defendant had stated he has cash on hand as of the date on which the government first purported to fix his net worth, the government could not rest on testimony by its expert witness that the defendant had no such funds on hand without offering some evidence to that effect. *Dupree v. United States*, 218 F.2d 781 (5th Cir. 1955).

The scope of the investigation may also be tested by a determination of whether those agencies were visited where public records showing acquisitions and dispositions of property are available. Similarly, where the evidence disclosed that a defendant formerly owned property, the Government may well be held to inquire as to the selling price of the property. The surrogate's court or its equivalent may well be the source of information on whether or not a defendant had been the recipient of property by will or by intestate succession. In like fashion the files of the Internal Revenue Service itself may provide some information on the receipt of gifts. These are but the more obvious sources of information and in particular cases the circumstances will indicate other sources which should have been investigated.

Failure to follow leads which the particular circumstances require, even though not suggested by the defendant, will bring a case within the authority of the rule which states that where an investigation is admittedly incomplete the jury cannot be asked to infer that the unaccounted-for increase in net worth over reported resources is unreported net income. This lack of completeness may be shown on cross-examination without a defendant ever having offered leads of any kind prior to trial, or evidence at the trial. The completeness of an investigation is in the first instance a question for the court. It is not a question to be submitted to the jury. This is so no matter how the test of the sufficiency of circumstantial evidence is articulated. The sufficiency of an investigation on which the government's case rests is not a disputed question of an ultimate fact such at the presence, absence, or acquisition of specific assets, but rather is a question of whether in fact an investigation in particular areas has taken place. In short, it is a question of the competence of the testimony offered by the government in support of the inference it seeks to have the jury draw and as such is for the court.

Objections to the net-worth method on the ground that the burden of proof is shifted to the defendant have been unavailing. Counsel will do well to recognize that net-worth cases are no different in essence from other criminal cases tried entirely on circumstantial evidence.

Must possible source be shown?

It had been for a number of years the position of the Department of Justice that it was necessary before a net-worth prosecution could be undertaken successfully to establish a source of income in addition to the source disclosed by the taxpayer in his return. In other words, prosecution would not be undertaken where the taxpayer's books and records agreed with his tax return and no specific items of unreported income could be discovered even though the net worth calculation showed substantial unaccounted-for receipts. There was no direct holding to the effect that a showing of such unreported income was the *sine qua non* of a net worth prosecution. The cases where the problem was discussed indicated that it had not been made a requirement.

To require a showing that income was received from sources other than those disclosed by a taxpayer in his tax return would in effect destroy the net-worth theory. This would be so since in order to establish that the receipts were not included in the return, it would be necessary either for the government to prove receipts of at least one dollar in excess of the gross receipts reported by the defendant, or that a defendant had income from a distinct source not revealed in his income-tax return.

It is enough if a possible source of income is demonstrated even though the source of the alleged unreported income is the same as the one disclosed by the taxpayer on his return. It is necessary to show in the possible source a potentiality of the income which is allegedly unreported. If the only source on the return is salary as a bookeeper and the alleged attempted evasion totals hundreds of thousands of dollars, then the requirement of a "likely source" is probably not met. From this it becomes clear that a source is generally demonstrated if the net-worth calculation discloses an excess of expenditures over reported resources even though a taxpayer's books and records are in agreement with his tax return. In short, the source requirement is largely a fiction.

The Supreme Court has gone even further by stating that a showing of a possible source of income may well be substituted by the government for proof that investigative leads have been followed up by the government. There is no justification for this dictum. The mere fact that a taxpayer has a possible source of unreported income should not relieve the government from the burden of exhausting the possibility that the excess of expenditures over available resources was made from nontaxable resources with respect to most of which there is no burden of disclosure.

It is not likely that the circuit courts will permit the government to substitute evidence of a proven or possible source of unreported receipts for evidence that it has gone to the records reasonably available under the circumstances in order to exhaust the possibil-

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ity that the defendant did not have nontaxable resources both in the tax years and in the period prior to the tax years back to the starting point.

In a prosecution resting on a failure to report specific items of income, it is enough for the government to show unreported gross receipts and to contend that they represent taxable net income. It is then necessary for the defendant to come forward with proof of the costs applicable to sales in excess of those disclosed by his tax return. Such a requirement is not unreasonable nor does it shift the burden of proof to the defendant, since as a practical matter it is unlikely that a taxpayer would exclude the costs applicable to the unreported sales usually involved. This line of cases, though arising in specific-item prosecutions, would appear equally applicable to net-worth cases. There is no requirement that the excess of expenditures over available resources be identified as economic net income or that the government prove that additional deductible expenses were not incurred in earning what is alleged to be unreported taxable net income.

Wilfulness

The above discussion has been concerned with proof of the actual net income unreported for tax years and with the proof of the net worth of the defendant as of the beginning of the first of the tax years. The willfulness aspect of net worth cases, from the point of view of the burden imposed on the prosecution, is probably of less importance than in an ordinary tax case involving unreported specific items. In the net-worth cases, the tests set out in *Spies v. United States* (317 U.S. 492) as some of the indications of wilfulness are likely to have been demonstrated in connection with proving income. The whole picture as is usually unfolds is one of an individual defendant conducting his affairs without benefit of records, doing business in cash, and engaged in illegal or quasi-legal activities. Specific evidence of additional acts of wilfulness is almost unnecessary. The very proof of the unreported income, in and of itself, will in most cases supply evidence on the basis of which the jury may find a wilful attempt to evade tax on the income proved by circumstantial evidence.

The bill of particulars

Counsel in criminal net worth cases operate at a disadvantage not experienced in other criminal cases. The defendant generally has few records and if the period involved is extensive, he cannot be relied on to supply the details of his financial transactions from memory. It will usually be found that most of the transactions took place in cash and cannot be traced. The government over a long period has, as a rule, reconstructed the financial history of the defendant in a more or less complete manner. This investigation takes a substantial period of time. Similarly the government has had at its disposal a vast investigative machinery. None of this is available to counsel for the defense or in fact to the defendant himself. It is no answer to a defendant seeking information to prepare a defense against a criminal charge that he should have kept better books.

The Federal Rules of Criminal Procedure with respect to bills of particulars have been given a very narrow construction. There is no reason for a failure to require the government to make a more full disclosure in bills of particulars than is generally required. The objection most often heard is that it may lead to manufacturing of testimony and documents where none in fact have existed. This is an argument not novel to the bill of particulars area. The same argument was made and rejected when fuller discovery was incorporated into the Federal Rules of Civil Procedure. If the government has made a full and complete investigation its evidence will in the main consist of documents. These documents having been available first to the government will either have been reduced to possession or will at least have been photostated. No prejudice will result to the government by making disclosure of the details of a defendant's net worth at least to the extent represented by the documents. Fairly detailed bills of particulars have been granted in a limited number of cases.

Even where detailed bills are granted, however, they usually relate only to the tax years. If the government at the trial attempts to establish a starting point at a point in time many years prior to the first of the indictment years, the prejudice to the defendant remains despite the furnishing of fairly detailed information for the indictment years.

If a bill of particulars seems awkward, the criminal rules provide a mechanism under rules 16 and 17 (c) for the disclosure of evidentiary matter resting on documents. The showing required in order to resist a motion to quash by the government is substantial and revolves about a showing of "good cause." For the same reasons that more liberal bills of particulars should be granted, the requirement of "good cause" should be more liberally interpreted.

One can well appreciate the position in which defendant's counsel finds himself on the eve of trial with no knowledge of just what the government's case is and how it is going to be presented. He has no choice but to resist every attempt to place in evidence each document which serves to show the sources of income to his client. The trial may well be expedited if counsel for the defendant has been able to make an investigation based on some disclosure of what the government intends to prove. At least counsel would have an opportunity to determine where and when he might be successful in resisting attempts to offer matter in evidence. A fuller disclosure by way of bills of particulars and pre-trial discovery under rules 16 and 17 (c) might, therefore, without prejudice to the government's case, serve to expedite the trial in these matters.

Net worth cases, resting as they do on documents, take an inordinate amount of court and jury time. They raise intricate points on the admissibility of documents. Often these difficulties are raised by the extreme age of facts in the case and the unavailability of the original documents and the principals in the transactions which are the basis of the government's case. Counsel for a defendant can protect his client's interest only by insisting upon rigid compliance with the rules of evidence as they relate to the admission of documents and the proper foundation for the admission of such documents. ☆

New decisions

Gambler's income, currently recorded by outside accountant, correct. A partnership which had engaged in illegal betting was held to have correctly reported its "hits" on winning slips in determining its income. The daily tapes summarizing the transactions of the day were sent weekly to an accountant, who entered them on a set of books from which he prepared returns. The Commissioner's action in reducing the amount of "hits" so that they represented only 28% of the gross receipts

is considered arbitrary. *Masucci,* TCM 1956-45.

Unreported sales taxable to officer in proportion to stockholdings. Taxpayer was president and part owner of two corporations, both operating auto agencies. His son managed one while he managed the other. The Commissioner increased his personal income on the theory that he received the excess when used cars were sold above the prices reflected on the books. Though the evidence was conflicting, the court held taxpayer failed to prove the Commissioner's error as to the sales made in behalf of the corporation managed by taxpayer. But there was no evidence to link taxpayer with the overcharges by the corporation managed by his son. However, since taxpayer had only 50% interest in the corporation he managed, only one-half of its unreported sales was attributed to him. It was unreasonable to assume that the holders of the other 50%, who knew of the overcharges, would permit him to keep all of them. Due to conflicting evidence the court found that the Commissioner had not met the burden of proving fraud. *Erwin,* TCM 1956-44.

Corporation was charged with the fraudulent activities of its officers who knew, or should have known, of the action. Taxpayer engaged in the manufacture and sale of fireproof doors and moving stairs. The Commissioner claimed that it filed fraudulent returns for 1945, 1947, 1948, and 1949. The statute of limitations was, therefore, not applicable and the 50% fraud penalty applied. His position was based on proof of unreported income of over $1,000,000; deductions claimed for officers' personal expenses; cash withdrawals for fictitious expenses; devaluation of the inventory by $200,000; and stock investments charged off as deductions. The corporation argued that all the fraudulent acts were attributable to its president, who was mentally incompetent, and the other officers knew nothing about them. The court held for the Commissioner. On the evidence, the President was competent. Furthermore, the other officers knew or should have known what was going on—their personal expenses were paid by the corporation, at least one of them signed the tax return each year, and the income diverted from the regular bank account was too large to be unnoticed. In addition, if the president was guilty of embezzling corporate funds, the taxpayer was not entitled to a deduction because the defalcations were subsequently repaid. *Peelle Company,* DC NY, 1/20/56.

Taxable income on sale of stolen goods. Taxpayer, owner of a hardware store, and one Schira, shipping clerk for a supplier, joined in a scheme whereby Schira took galvanized merchandise from his employer's warehouse which taxpayer received and sold. They shared equally in the proceeds. Deficiency determinations and fraud penalties are sustained against taxpayer since she failed to prove that she did not understate her sales. *Bennett,* TCM 1956-34.

Schira claimed he could not be taxed on the income attributed to him because he embezzled the goods rather than stole them, and embezzled money does not constitute income. The court disagrees, holding that the money received on sale of the goods was received under a claim of right and represented income which should have been reported. *Schira,* TCM 1956-35.

Filing correct returns late won't prevent fraud penalty. If an intent fraudently to evade tax is shown, the 50% fraud penalty will be assessed even though the taxpayer, after filing fraudulent returns, later filed returns which, though delinquent, showed the correct tax liability and paid the tax and interest. *Rev. Rul.* 56-54.

Family partnership invalid; fraud sustained against husband. The court refused to accept an alleged husband-wife partnership in commodity transactions where there was no evidence of a partnership agreement, no partnership return was filed, the wife contributed neither capital nor services, and all transactions were in the husband's name. Fraud penalties were sustained against the husband in spite of his limited education, since he had engaged in commodity transactions for over 25 years and grossly understated the true amount of his capital gains without valid excuse. *Murray,* TCM 1956-31.

Repeated omissions of compensation evidences fraud. Taxpayer who managed and supervised a monument business owned by his mother failed to include in his income compensation for services rendered to the business. His substantial and repeated understatements of income over the period 1944-1946 are held to evidence a fraudulent intent to evade taxes. *Collin Estate,* TCM 1956-32.

Plea of guilty to wilful tax evasion is evidence of civil fraud. An attorney who omitted monies received from clients in adoption proceedings failed to show that any part of the sums were not income, or that they should be allowed as expense deductions. The civil-fraud penalty of 50% is sustained because of substantial omissions, and because of taxpayer's plea of guilty to criminal tax evasion for the same years. *Siegal,* TCM 1956-28.

Understatement of income to hide over-ceiling payments fraudulent. Taxpayers, in operating several restaurants, maintained two sets of records. The second set, which was used in the preparation of the returns, admittedly showed an understatement of gross receipts, but taxpayers contended that the understatement was compensated for by an omission of expenses for over-ceiling wages and payments above OPA prices. The court holds the then wage and price laws specifically proscribed tax deductions for such payments and upholds the deficiencies and fraud penalties. *Masters,* 25 TC No. 123.

Failure to file prepared returns fradulent. Taxpayer's returns for 1948 and 1949 had been properly and timely prepared by an independent accountant but were never signed or filed. As the returns showed a substantial tax liability, taxpayer decided to use the tax moneys more profitably for other purposes. The failure to file was held to be fraudulent. However, no fraud was found for failure to file a 1950 return, since that year's form as prepared by the accountant showed a loss and no tax due. *Jones,* 25 TC No. 124.

Bookmakers, without records, fail to rebut deficiency determination. Operators of a bookmaking business maintained no partnership books but employed an accountant to prepare their returns from monthly totals of wins and payouts which they tabulated for him. The Commissioner's determination of additional unreported income and his reduction of the amount of payouts was upheld as not being arbitrary. Penalties for negligence and for failure to file declarations are sustained. *Inukai,* TCM 1956-51.

NEW DEVELOPMENTS IN

State & local taxation

EDITED BY JOSEPH S. MARTEL

Property tax system needs radical overhauling to be equitable, effective

by ROGER A. FREEMAN

Though the property tax is an essential part of state and local government, its present administration is shockingly unfair and illogical. Exemptions, rate limitations, assessment practices, and the practice of electing administrators all combine to make a hash of what ought to be an objective and efficient governmental operation. This author's analysis of the present situation leads him to recommend that local tax administrators be appointed, not elected. He urges that courts, legislatures, and taxpayers unite to have the entire system removed from politics and run along scientific, objective lines.

UNTIL ABOUT TWENTY YEARS ago property in this country was burdened with too great a share of the cost of government. Property tax collections totalled more than all other taxes — federal, state, and local — together. The picture has changed drastically in the past quarter century: for some years now property taxes have accounted for only 11% of all taxes. To be sure, property tax collections have not declined. They mounted from $700 million at the turn of the 20th century to $5 billion in 1929, and to $9.3 billion in 1953. But other taxes outpaced the property tax. Governments in the United States now derive 63% of their tax revenues from income taxes, more than in any other country in the world, and 26% from excise taxes, less than in any other country.

Property taxes claimed about 5% of our national income in the early part of the 20th century, took 6% in 1929, jumped to 12% during the depression years, and fell back to 6% by 1939. In recent years property taxes have equalled about 3% of the national income. All other taxes totalled 5% of the national income early in the 20th century and until about 1930; since then they have soared to 25% of the national income. This radical shift in the tax burden from property to income and sales probably exceeds the fondest hopes of those who fought the excessive property taxation 20 and 30 years ago.

But the property tax still is an essential part of our tax structure. As long as the over-all burden is as heavy as it is, we must of necessity diversify the forms of taxation by which we measure each man's contribution. Ad-valorem taxes, which are gauged by the ownership of property as a major economic resource, serve to provide a better balance of the burden of government.

Moreover, no other tax is equally well suited for imposition by small local jurisdictions. Land and houses stay put. The continued existence of local government seems to be tied to the property tax base.

In the past two decades other sources of municipal income have sprung up: sales, business, and income or payroll taxes. They contributed 3% of the tax revenue of local governments in 1932, 8% in 1942, 13% in 1953. But 87% of all locally collected taxes still come from property. Even in cities, property taxes account for three out of every four tax dollars. Between 1942 and 1953 local government expenditures went up $12.2 billion; only $1 billion—less than one-tenth—came from local non-property taxes.

Why property taxation decreased

The relative decline of the property tax in the past 20 years was caused by several developments:

1. State government, which used to receive a substantial part of its income from property taxes, virtually withdrew from the field.

2. Several major functions which had been responsibilities of local government were partially or completely shifted to state or federal governments. This is particularly true of public welfare, roads, and schools, the largest areas of non-federal governmental activity.

3. State and federal payments to local governments climbed from $56 million in 1902 to $605 million in 1927 and to $5.7 billion in 1953. They equalled 8% of locally-collected taxes in 1902, 14% in 1927, and 55% in 1953. The states in turn started leaning increasingly on the federal treasury. Federal aid to states rose from $3 million in 1902 to $107 million in 1927 and to $2.6 billion in 1953. In fiscal 1955 it exceeded $3 billion.

The intended purpose of grants-in-aid was the expansion of local services. But they also served to relieve local taxation.

The needs of the activities which are currently financed by local governments are rising rapidly. The next ten years will see a population growth of 25 million, the greatest increase in any 10-year period in our history. Two-thirds of that increase, more than 17 million, will be in the age brackets under 20 or over 64 years. Services for both groups will need to be vastly improved. Last not least, there already exists a multibillion dollar backlog of needed physical facilities—schools, hospitals, sewer and water works, etc. All this means that the expenditures of local governments will mount steeply. The question is whether the funds will be raised locally or at state and federal levels.

Possible future policy

The relative decline of the property tax in the past 20 years has been a major factor in the shift of responsibility and decision-making power from the local level to the state and from the state to the federal government. Looking toward the future we seem to face a choice between two alternatives:

1. We can continue the trend of transferring activities and responsibilities to

higher levels of government. We can easily foresee that such a policy will slowly but surely turn local governments—and eventually state governments—into mere field offices of the federal government.

2. We can strengthen the fiscal powers of local government so that it can cope at least with its remaining responsibilities. This process will inevitably include a program of vitalizing the property tax.

Current administrative weaknesses

If we are to follow the second alternative we shall need to correct the major shortcomings of the present property tax administration. They are:

1. *Exemptions.* The number of tax exemptions has been increasing to a point where we are dealing less and less with a "general" property tax. Thirteen states grant homestead exemptions; 16 states grant veterans' exemptions from $500 up to $5,000 assessed value. Because assessed values are only a fraction of current values, far more residential property escapes taxation than was intended. About a dozen states permit the exemption of new industrial property. Eight states do not tax personalty and a number of states make other concessions. Various studies have shown that exemptions are an ineffective and costly method of attracting industry. Exemptions are of course very popular with the groups for whose benefits they were enacted. But it is not widely realized how great an additional burden they place on unfavored property owners

The federal government enjoys immunity from local taxation. A few agencies make payments in lieu of taxes—TVA, Atomic Energy Commission, Housing and Home Finance Agency. Other departments share revenues with state and local governments (forests, grazing, minerals). Some assistance is given to schools in federally affected areas. But many of these payments fall short of a fair contribution to local government. What is needed—and was recommended by the Commission on Intergovernmental Relations—is a comprehensive system of payments in lieu of taxes in those cases where the federal government acquired land or buildings in recent years and operates facilities which serve essentially national purposes or commercial operations.

Much state and local government property which is used for proprietary operations, particularly in the utilities field, escapes taxation. Its share is shifted to the general taxpayer.

2. *Rate limitations.* Limitations on property tax rates have been used for almost a century but became more widespread in the early nineteen thirties. Nine states now have over-all rate limitations. Almost all states limit the property-taxing powers of their political subdivisions. These limitations were established at a time when the scope and standards of public services were much lower than they are today. Debt limits which in almost all states are based on assessed valuations frequently prevent local governments from financing school buildings and other badly needed improvements. These taxing and bonding limits are often cut to one half, one third or less of their statutory level by the practice of assessing property at a fraction of its full value.

3. *Fractional assessment.* Constitutional and statutory provisions notwithstanding, property has never been assessed at full value, with rare exceptions. In 1929 real estate assessments in the U. S. totalled $135 billion. It was estimated at the time that the true value was about twice as high. Since 1929 building costs have risen about 150%; we have built 13 million homes at a value of $113 billion and more than $100 billion worth of commercial, industrial, and other private construction. Deducting depreciation, abandonments, etc., the value of real estate may now be estimated at between $600 and $700 billion. Real estate assessments in the U. S. total only $200 billion. In other words real estate is on the average assessed at less than one-third its current value. That varies, of course, from state to state, the ratio in New York being 65%, in Washington 20%, in Idaho 13%.

Fractional assessments

Sometimes fractional assessments are rationalized by claiming that current prices are inflated. What is inflated is not the prices but our currency; we are dealing in 50 cent dollars. The price of real estate is expressed in the same dollars with which we pay taxes and with which cities and schools must pay their salaries and other costs. The statement that assessments are set at "normal' values is an attempt to evade the clear mandate of the law. Nobody ever suggested that income be assessed for tax purposes at its 'normal" value or that sales taxes be computed on 1940 prices of merchandise. Appraisals of real estate for other than tax purposes—for banks, insurance, loan companies, prospective buyers—do not seem to be plagued with a concept of "normal" value.

In the 25 states where the state government still receives some share of the property tax collections, there is positive encouragement to competitive underassessment as a means of minimizing local contributions. Twenty four states distribute grants-in-aid on formulas based on local wealth as evidenced by assessed values. This system penalizes correct assessment and rewards underassessment. The so-called equalization ratios used in some states are, with few exceptions, fictitious. In 37 states local taxes are levied on state-assessed intercounty utility property. The owners of such property are almost universally being overtaxed. The New York system of basing tax and debt limits not on assessed values but on valuations adjusted to full market value effectively corrects the ills of fractional assessments.

4. *Uniformity of assessments.* The laws of most states prescribe that property be assessed uniformly (if sometimes by classes). No law is more flagrantly broken. John Sly said in his New Jersey property tax study, which he significantly captioned *A Century of Inequities*: "Never has so much money been raised from so many people so inequitably as in the current administration of the local tax on real estate." Uniform treatment, he said, was undiscoverable except in isolated instances. The ratio of assessed to full value among the 21 New Jersey counties varied from 16% to 56%. A recent Kansas study showed that county ratios varied from 12% to 49%. A Pennsylvania study showed variations from 20% to 78%, an Idaho study from 9% to 26%, a Washington study from 13% to 38%. The examples could be multiplied.

Intra-county variations

Variations within counties are even greater than among counties. The mentioned reports found much property assessed at 10% or below. Much property that had had buildings for years was listed and valued as vacant lots, or did not appear at all. The school superin-

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JOSEPH S. MARTEL DIES

Joseph Sully Martel, editor of this department and until his retirement in March a vice president of McKesson & Robbins, Inc., died in Houston, Texas, on April 28. One of the best known and most widely respected of tax men, he had few peers in knowledge of the principles, practice, and people of state and local taxation.

tendent of Cook County, Illinois, recently went on a hunting expedition for unlisted property. He believes that when he completes his survey he will have uncovered at least $40 million worth of property that should have been assessed but has not appeared on the tax rolls.

Are we making progress in getting all property on the rolls and making assessed values more realistic? Very slowly at best. The National Association of Assessing Officers found in a survey that real estate assessment in jurisdictions which account for about 30% of the national total had risen $2.2 billion from 1953 to 1954. But new private construction in 1953 totalled nationally $23.9 billion. So the increase in valuations equalled only a fraction of just the new construction.

Variations among individual pieces of property and omissions are due to incompetence of assessments, to insufficient staffing, and to failure to use up-to-date technical aids. Assessors' offices are frequently given inadequate budgets. Variations among classes are due to a deliberate if illegal policy. Rural property may be assessed higher or lower than urban property. The New Jersey study found that commercial property was assessed at an average of 49%, residential property at 29%. In Cook County, Illinois, residential property is assessed at 30%, commercial property at from 50% to 70%. In Washington residential property is assessed at an average of 19%, commercial property at 27% to 38%. The reasons for these discrepancies are patent: there are more votes among owners of residential property than of commercial property.

The assessment of personal property is even worse than that of real property. The New Jersey report calls it a scandal and a hazard.

"Home rule" doctrine misapplied

What all this adds up to is a breakdown of local property tax administration. The situation exists only because taxpayers do not know how bad it is. Many governors have bitterly criticized the sorry condition of property tax assessments. With rare exceptions, legislatures have closed their eyes to the disgraceful situation or at best have taken half-hearted action. Courts have a record of more often hampering rather than helping attempts to correct these injustices. They seem to have difficulty distinguishing between the appraisal of property, which is a technical process, and the power of taxation, which is part of the political process. There has been a reluctance to interfere with arbitrary and illegal methods because of a mistaken concept of "home rule."

Assessors should be appointed

We may ask: why is it that the property tax is in such bad shape while other taxes seem to be fairly well administered? What distinguishes the property tax from all other taxes?

The property tax in the United States is older than other taxes; its organization and methods are hopelessly outdated. In no other tax field do we elect local administrative officials. But the great majority of property tax assessors are elective. It is quite likely that our income-tax administration would be in no better shape if the employees of the Internal Revenue Service were locally elected without regard to technical qualifications.

The appraisal of property, like the verification of income-tax or sales-tax returns, is a technical job which requires professional skill and knowledge. It is not supposed to be a policy-making job. The employees of the Internal Revenue Service or of the state tax department do not claim the discretion to apply the tax rates to 30% or 50% of a taxpayer's income or sales volume. But property tax assessors exercise such an authority.

The question is sometimes asked what difference it makes whether the size of the tax levy is raised or lowered by manipulating assessments or by adjusting tax rates. The difference is that the policy decision is shifted from the legislative body to a single official. Instead of the representative bodies which are responsible for the operation of their governmental units, it is often the tax assessor who decides how much they can spend.

A long and disgraceful record has proven that local property tax administration except in rare circumstances does not function adequately. Sporadic attempts at improvement by local initiative or under state stimulation have at best been only temporarily successful. If we want property tax assessment to cease to be a political football then we must put it on a scientific and objective basis. An increasing number of people are coming reluctantly to the conclusion that this will not be accomplished until the appraisal of property is divorced from local discretion and bound by the same rules by which intercounty utility property is appraised in most states: uniform standards on a state-wide basis, uniformly applied. ☆

Sharp increases seen in state, local taxes for 1965

IN ITS NEW STUDY, *Government Finances in 1965*, the Tax Foundation foresees a sharp increase in state and local tax burdens and cites the possibility of a decline in federal tax rates. Given the current trends in the level of business activity, however, the study sees an overall lessening of the tax burden at that time.

Citing Census Bureau estimates of the population growth in the decade, the study notes: "The implication of the population projections for state and local expenditures is clear. In 1953, expenditures for education made up more than a third of all state and local government general expenditures, and 42% of local government general expenditures . . . .

"With a 41% projected increase in the 5-19 age population, it may be expected that the most important need and demand for increased government services in the next decade will be in education."

The study says that government revenues and many categories of spending in 1965 "clearly will depend upon the growth of the economy over the next decade." Changes in tax rates aside, revenues will be governed largely by the growth in personal and corporate income and expenditure.

The population increases projected appear to imply, says the Foundation, a "high level" of business activity over the next decade. "Productivity per worker apparently will have to increase more than in the past to keep pace, certainly with needs, and probably with demands, for output. "These projections, it is said, suggest that inflationary tendencies should outweigh deflationary tenden-

cies" over the next decade.

Noting that the federal spending figures for 1965 "are more in the nature of possibilities than projections," the study estimates they could top 1953's high by eight per cent, and conceivably might dip 11% below that level.

The study assumes $40 billion (approximately the 1955 level) as a high for national security expenditures a decade hence, and $30 billion as a low. A $10 billion reduction in defense spending would approximately offset, says the study, the projected increases in other federal expenditures.

If national security spending should be reduced to about $30 billion in 1965, and "conservative" estimates are made of other federal spendings, "Federal general expenditures should be reduced by some $14 billion from the 1953 level," says the study. With this picture (and at the 1955 level of tax rates), "there would be a federal surplus in 1965 of $20 to $34 billion, excluding insurance trust fund accounts. If all of this possible surplus were used for tax reduction, current tax rates could be reduced by 23% to 39%."

In the face of a projected population growth (19% in the 1953-1965 period), and a likely rise in the gross national product, the study projects these significant factors of state and local government:

Expenditures for education should nearly double over 1953's figure of $9.4 billion—to a possible high of $18.8 billion.

Spending for highways ($5 billion in 1953) should also nearly double—to a possible high of $10.4 billion. The possibility of a "large increase" in federal aid for highways is envisioned. A low of $1.5 billion and a high of $2.5 billion is assumed for 1965.

The study concludes: "It is beyond the purpose of this study to make judgments on how tax rates, intergovernmental payments, and expenditure programs ought to be changed. But it is likely that state and local tax rates, particularly property tax rates, will be raised to meet at least part of the prospective 'deficit' in state and local finances.

"And it is likely that the prospect of a large Federal surplus will lead to some reduction in federal taxes . . . but even though state and local expenditures increase relatively little as a percentage of a rapidly growing gross national product, the absolute increase in these expenditures will be very large. Extremely difficult tax problems are virtually assured for state and local governments for the next ten years." ☆

New decisions

The following reports on significant new state tax decisions are provided through the cooperation of the Federation of Tax Administrators. They are adapted from Tax Administrators News.

Income tax on interstate business upheld; Spector distinguished (La.) The imposition of Louisiana's net income tax on a common carrier engaged exclusively in interstate commerce was upheld by the Louisiana Supreme Court in *Fontenot v. John I. Hay Co.*, decided December 12. The taxpayer, a foreign corporation which maintained an office and employees in the state, was engaged in bringing cargoes by watercraft into and through Louisiana and taking cargoes out of the state. It contended that the tax violated the commerce and due process clauses of the federal Constitution.

Louisiana's income-tax law taxes foreign corporations on net income from sources within the state determined on an apportioned basis. The court held that the tax, neither in form nor in substance, was imposed on interstate commerce. It emphasized that it was neither a gross income nor a franchise tax and was imposed only after the taxpayer had ascertained all of its profits, losses, and expenses resulting from business conducted in Louisiana. It held that the United States Supreme Court decision in the *Spector* case in effect substantiated the validity of the Louisiana tax. The tax struck down by the high court in the *Spector* case was a privilege tax imposed on interstate commerce, the court said, while the Louisiana tax was on income earned in the state, not in the right to transport goods on waters located in the state.

California "market value" standard requires capitalization of anticipated actual income. In *De Luz Homes Inc. et al. v. County of San Diego,* decided November 25, 1955, the California Supreme Court held that in valuing a possessory interest for property tax purposes by the capitalized income method it is improper, when deriving the net income to be capitalized, to deduct from gross income an amount representing amortization of investment and rent paid for a leasehold interest.

The case involved a Wherry Act military housing project constructed on hand leased from the United States. The lease was for 75 years, subject to termination by the government in 50 years, at $100 annual ground rental, and provided that all taxes with respect to or upon the leased premises were to be paid by the lessee. The buildings and other improvements erected by De Luz became the property of the United States as they were completed, but all net income from subrentals was the property of De Luz.

The assessor had imputed an income (before taxes) to the possessory interest by applying an 8% rate to the fee value of the property (found by methods used in valuing similar property in the county) less a deduction for restrictions imposed by the lease. This imputed income, reduced by the (equalized) land rent and capitalized at 8%, gave present value, which, after an adjustment for overlooked burdens, was regarded as taxable value.

The trial court directed the county board of equalization to derive annual net income by deducting from gross income operating expenses and an amount sufficient to amortize investment in the property. The remainder capitalized at 6% (plus an allowance for taxes), and equalized at 35%, was to be entered on the tax rolls. In its specific findings the court found the possessory interest to have no present value: when separately capitalized for 52 years, the value of the taxpayer's net burdens until repayment of the mortgage in 1986 exceeded the value of net benefits accruing thereafter.

The Supreme Court rejected the methods of both the assessor and the trial court. The latter erred in allowing a deduction from gross income for amortization of the present owner's investment; California's market-value standard requires capitalization of anticipated income of a prospective purchaser rather than the present owner's earnings. Allowing investment amortization is faulty both because it assumes a preknowledge of value and because the capitalized-income method automatically provides for a return of capital. Similar-

ly, a deduction for rent paid by the present owner, which is part of the value of the property to the purchaser, is an allowance for investment which can be properly reflected only through an adjustment in the capitalization rate. In allowing a rent deduction both the trial court and the assessor erred.

The board of equalization was directed to take new evidence on anticipated actual income (rather than imputed income used by the assessor), operating expenses, and a proper rate of capitalization. Taxable value of the possessory interest is the net income so derived capitalized for the remaining years of the lease.

California sales tax on liquidating sale of utility. A private street railway company's sale to San Francisco of all its operating property was held subject to California sales taxes, the California District Court of Appeals, First District ruled in *Market Street Railway Co. v. State Board of Equalization,* on November 18. From 1933 through 1948, the company had negotiated about 900 sales of its property totaling almost $3 billion of which $2.9 billion represented the transfer of its operating properties to the city. The company had paid under protest taxes, penalties, and interest due on these transactions.

The court ruled that the sales were taxable under the California law which imposed a tax for the privilege of selling tangible personal property on all retailers measured by the gross receipts of all tangible personal property sold at retail. It held that the company constituted a "retailer" and its sales as "retail sales" in accordance with the terms of the statute. Under the law, the "retailer" category includes every person making a sale at retail; a "retail sale" is a sale for any purpose other than resale in the regular course of business in the form of tangible personal property. "Business" is defined as any activity engaged in with the object of either direct or indirect gain, benefit, or advantage.

The court denied the company's contention that it could not be a retailer since it was engaged in the business of rendering services. The court held that a company could be both a consumer and a retailer and that its 900 retail sales placed it in the latter category even though it was a consumer of materials with respect to its principal activity. Since the sales tax was on the privilege of engaging in business, the company argued that it could not be imposed on liquidating sales. The court denied this argument in the absence of any express exemption in the statute.

Still another point was made by the company. Until October 1, 1944, two days before the sale, the Board of Equalization excluded from tax "any portion of the consideration paid in connection with the sales of an entire business." Two days after the effective date of the sale, the regulation was changed to apply the tax to that portion of the sale of an entire business representing the retail value of tangible personal property acquired for use rather than resale by the purchaser of the business. The company contended that since it had relied on the earlier ruling in failing to report its sales, the state was estopped from collecting taxes, penalties, and interest. It justified its claim for estoppel on the basis that the sales tax act provided that the tax be collected "from the consumer insofar as it can be done." The court ruled that the state may be estopped where the taxpayer is a mere collecting agency, but not where the tax is imposed on the complaining taxpayer. While the seller could pass the tax on to the buyer under the California law, the court held that the tax itself is imposed on the seller and the payment of it was his primary obligation. The court, however, granted estoppel with respect to penalties and interest due on the sale of company properties to the city and on other sales made prior to its knowledge of the change in regulation.

Limitation on deductions of nonresidents constitutional (NY). Nonresidents are not discriminated against by a New York law which allows them deductions "only if, and to the extent that they are connected with income arising from sources within the state and taxable to a nonresident taxpayer," the New York Appellate Division Third Department ruled in *Goodwin v. State Tax Commission,* on November 16. The taxpayer in the case resided in New Jersey but earned his entire income in New York. In his state income-tax return he was allowed deductions for expenses connected with the production of his income and for certain charitable contributions. He was denied deductions for New Jersey real-estate taxes, interest on his home mortgage, medical expenses, and life insurance premiums up to $150. He challenged the constitutionality of the statute on the basis that the deductions denied him were allowed New York residents.

In upholding New York's law the court cited United States Supreme Court decisions in *Travis v. Yale & Towne Manufacturing Co.* and in *Shaffer v. Carter,* which upheld the right of a state to tax the income of nonresidents and to allow residents to deduct losses both within and outside the state while limiting nonresidents to the deduction of losses incurred within the state. In the instant case, the court ruled that a provision limiting deductions by a nonresident to those connected with income-producing activities in the state is a necessary corollary to the principle of federal constitutional law which allows a state to tax only nonresident income derived from sources within its boundaries. Conversely, since residents are subject to the state's plenary taxing power, the court said they may be taxed on all income irrespective of source and, appropriately, be allowed deductions not connected with income-producing activities in the state. Accordingly, the court found no discrimination against nonresidents in New York's income-tax law.

Tax on California banks upheld. After lengthy litigation, California's franchise tax as imposed on national banks has been upheld by the California Superior Court, Sacramento County in *Security-First National Bank of Los Angeles v. Franchise Tax Board* in a memorandum opinion given January 14.

California's corporation franchise tax is on the privilege of doing business and is measured by net income. Under its provisions corporations are taxed at a 4 percent rate, but the rate on banks and financial corporations are determined annually on a "built-up" basis which may not exceed 8 percent. The rate imposed on banks is the equivalent of the percentage that franchise taxes and personal property taxes paid by every corporation bears to total corporate income. The purpose of the "built-up" rate is to eliminate discrimination in favor of banks against other corporations resulting from the tax immunity of the former from personal property taxes.

The court held that the California tax corresponded precisely to the fourth method of taxing national banks by Congress in Section 5219 of the Revised Statutes. This act, by amendment, authorized the taxation of national banks

according to or measured by the net income of the bank, with the provision that the rate be no higher than the highest of the rates upon mercantile, manufacturing, and business corporations. The court held that there was no doubt that the word "rate" as used in the act referred to comparative tax burden and not to arithmetical rate.

It is recognized that misclassifications have resulted at times in a higher "built up" rate than would have been applied otherwise. However, the court concluded that a rough approximation is all that is to be expected and that if the standards established by the federal law are not violated the method is valid, even if the taxpayer is able to prove some errors in the computation process.

Steel firm taxed on gasoline sales to its employees, tenants, and customers (Mich.). A Michigan firm which was engaged in the business of buying and selling steel and which operated a steel warehouse also sold gasoline and related service-station products to its own tenants, employees, and to truckers hauling their products. The firm paid Michigan sales taxes on its steel operations but contended it was exempt from tax on the proceeds of its service-station sales because they were not transactions in the ordinary course of business and represented the furnishing of services which were nontaxable rather than the sale of commodities. Taxpayer claimed that the gasoline and other station products were sold at cost with only a few cents added for the service rendered.

The taxpayer's contentions were denied and the sales in question held taxable by the Michigan State Board of Tax Appeals on September 30, 1955 in *Rolling Mill Products Co., Inc., v. Department of Revenue.* The board ruled that even though the sale of gasoline and service-station products were limited to certain customers and were a comparatively small percentage of the taxpayer's total sales, the transactions represented the transfer of tangible personal property for consumption and use to others and therefore came within terms of the state sales tax act. The board pointed out that the taxpayer's contention of a separate "service charge" was not supported by customer billings.

Road use tax on private interstate mail carrier upheld (Va.). Dismissed for want of a federal question was an appeal in *Crowder v. Commonwealth of Virginia* in which the Virginia Supreme Court of Appeals upheld the imposition of the state's road-use tax on a private interstate carrier delivering the mails for the federal government. The road-use tax was imposed on the carrier's gross receipts apportioned according to the ratio of miles traveled in Virginia to total mileage. The Virginia court dismissed a contention that since transportation of the mails is exclusively a federal function, the taxation of a contractor engaged solely in the carriage of mail upon terms and conditions fixed by the Post Office Department resulted in a burden on the federal government.

Use tax on property destined for interstate system valid (Iowa). The purchase of tangible personal property from out-of-state by an interstate pipeline company for use in the construction in Iowa of compressor stations and various buildings for the housing of employees of the company was ruled a taxable transaction under the state use tax by the Iowa Supreme Court in *Michigan-Wisconsin Pipe Line Co. v. Johnson,* decided December 13. The company operated a pipeline system transporting natural gas from points in Texas through several states including Iowa to Michigan, Wisconsin, and other points. It contended that the purchases in question were exempt from the Iowa use tax under a provision which exempted property used in interstate commerce and because their taxation would result in violation of the federal commerce and due process clauses.

In ruling the purchases taxable, the court held that the property, when brought into the state prior to its actual installation, had not then become a part of the interstate transportation system. The court stressed the fact that the tax was for the use of the property in Iowa and not upon a business of an interstate nature. Consequently, it ruled, there was no basis for construing the tax as imposed on interstate commerce.

Sales tax due on sign rentals; not on repairs (Utah). A taxpayer engaged in the manufacture, maintenance, and rental of electric signs is subject to Utah sales taxes on rentals but not on charges for repairs, the state supreme court ruled in *Young Electric Sign Co., Inc. v. Utah State Tax Commission,* decided September 28. In its billings for repairs, the taxpayer did not separate charges for services and materials. However, it determined that only about 6% of the billings were for materials. The court held that use of materials was only incidental to the services rendered and could not be assumed to constitute a substantial portion of the total outlay.

The taxpayer also claimed that more than 50 percent of its receipts from rental agreements were charges for repair and maintenance and therefore were not taxable as sales. It cited a provision in such agreements which required the installation, maintenance, and repair of the rented signs by the taxpayer. The court, in this instance, ruled that rentals were specifically taxable under the sales tax law and that the elements which entered into such charges were not relevant to the question of taxability.

One justice dissented from the majority's ruling that the repair charges in question were tax-free since material costs constituted only 6% of the total. The dissent stressed that the 6% ratio reflected the cost of the materials to the seller, not the markup passed on to the customer, the magnitude of which the taxpayer had not divulged. From the point of view of equity and practical administration, the dissenting justice contended that the company should be compelled to collect the sales tax on the fair selling price of the materials, or if it would not disclose this information, then on the total billing.

Sales tax attaches when trucks stop in state for changes (Mich.). Michigan's sales tax was properly imposed on sales of trucks to an automobile delivery company when title to the trucks passed in Michigan although they were ultimately destined for out-of-state use, the Circuit Court of Ingraham County, Michigan ruled in *Department of Revenue v. Jerry McCarthy Highland Chevrolet Co., Inc.,* decided November 14. In ordering the trucks, the company stated that delivery was to be made to a steel firm in Detroit. Upon delivery to this firm, certain mechanical changes were made in the trucks after which they were sent to several out-of-state terminals operated by the purchasing company. In an earlier review of the case, the state board of tax appeals had ruled that the momentary stopping of the trucks did not constitute delivery and that insufficient "local activity" had occurred to make them subject to Michigan sales taxes. The court, however, reversed the board's ruling.

NEW DEVELOPMENTS IN

Payroll taxes

EDITED BY PETER G. DIRR

Department opposes proposed increase in minimum social security benefits

THERE'S BEEN a good deal of talk about increasing the minimum social security benefits to $55, $60 or $75 per month. We explained these a year ago (2 JTAX 247), saying that before the 1954 Social Security amendments passed Congress a provision was made requiring that a study be made with the view to determining the feasibility of increasing the minimum old-age insurance benefit.

This study was undertaken by the Department of Health, Education, and Welfare and the results of the study are now available. The report embodies some eighty pages including numerous charts. The Summary and Conclusion should be of interest to all tax practitioners. It reads as follows:

"As has been indicated, the proposed increases in the minimum would result in appreciable increases in the cost of the OASI program. The increase in cost on a level-premium basis for the $55 minimum would be 0.6% of payroll; for the $60 minimum, 0.9%; for the $75 minimum, 1.8%.

"With a $55 minimum the savings in Federal grants to States for old-age assistance would amount to about 4% at present and about 8% in 1960. The comparable figures for a $75 minimum would be 10% now and somewhat under 19 per cent in 1960. The additional expenditures for OASI in 1955 would amount to from 5 to 7 times the reduction in the Federal share of assistance costs; for 1960 from 8 to 11 times.

"Those who would benefit from the proposed increases in the minimum, aside from those people now on the rolls, would be widows whose husbands died before the recent improvements in old-age and survivors insurance, families where the wife had barely enough covered work to be insured, and people who had spent most of their lives outside of covered work such as doctors, lawyers, Federal employees, and investors. In addition there would be some regular lifetime workers in low-wage areas, such as Puerto Rico and the Virgin Islands, or in farming, with its low cash wage and considerable remuneration in kind. The chief group that would hurt by reason of paying additional contributions without any benefit increases would be the regular, full-time, lifetime workers who supported themselves and their families throughout their lives by work in covered jobs.

"It would seem very difficult to justify to the long-term contributors to the system, who even under present law receive less in proportion to their contributions than do the short-term contributors, that they must pay still higher contributions to help finance benefit increases for others while not getting additional benefits themselves. Especially would this be true when it is considered that among those who would receive the increased amounts would be self-employed doctors and lawyers, Federal workers, investors and others whose major source of support—income from noncovered work or investments — is not subject to the taxes that support the program.

"Thus the provision of high minimum benefits not only would increase the cost of the program but it might also jeopardize the financing of the program by decreasing the willingness of the long-term regular worker to support the system. In the opinion of the Department of Health, Education, and Welfare there are values inherent in the contributory, variable-benefit system that make it most important that no step be taken, however expedient it may seem in the short run, that would weaken the financial basis of the system." ☆

Relief from withholding likely on non-cash pay

IN NOVEMBER of last year we drew attention (3 JTAX 312) to the problem and unfairness of HR 542, which became law in August 1955, which exempted non-cash payments to retail commission salesmen from provisions of the withholding law. We pointed out at that time that it would not seem equitable to grant this exemption only in the case of retail commission salesmen. Our comments drew support from various authorities. A later article written by Leslie Mills of the New York office of Price, Waterhouse and Company had this to say:

"This is the type of legislation which leads to undue complications in the tax law. The problem is real, since it makes little sense to have to ask a salesman for cash for tax withholding when he wins an automoble in a sales contest, nevertheless a narrow provision like this is obviously tailored to a specific problem, and does not represent sound policy for the tax structure. It is inevitable that expansion will be demanded to fit other needs."

Now we are pleased to note that on March 15, a bill (H.R. 9971) was introduced in the House of Representatives by Congressman Keogh which would grant the same exclusion from withholding to all non-cash remuneration paid to all employees who are ordinarily remunerated solely by way of cash.

This bill has been referred to the Committee on Ways and Means.

The time would seem to be right for employers and practitioners to request favorable consideration of this bill. It involves no loss of revenue whatever. It is merely a simplification which will eliminate one of the headaches presently confronting employers. ☆

The poor employer! more withholding

WITH WITHHOLDING taxes becoming more general and an ever increasing problem to employers, Kentucky has taken a step which may be the straw that breaks the camel's back.

Already employers in the City of Louisville, for instance, are required to withhold from employees, Federal Income Tax, State Income Tax and City of Louisville Income Tax. Add to this, then, the enabling legislation which was approved by the Governor on February 24, 1956 whereby a license tax on wages of no more than ½ of 1% may be imposed by any Board of Education located in a county containing a city of the first class (Louisville only).

Luckily, before any Board of Education can levy this new withholding tax, it must first adopt a resolution indicating its intention to impose the license tax following which it must be presented to the voters of the School District at a special election called by the Board.

Perhaps the referendum will save the day. ☆

Delaware proposes entirely new type of payroll tax

DELAWARE has in its legislative mill a new kind of payroll tax which bears watching. It seems new in concept, and not in harmony with our present ideas of revenue raising.

The proposal passed both the House and the Senate in February. It seems that immediately after passage of the bill the Delaware Legislature recessed. The bill was not signed by the presiding officers of the House and Senate and never did go to the Governor. Now it has been recalled by the Senate and referred to the Senate Finance Committee where it will remain until the Legislature reconvenes on May 28.

Latest word is that certain legislators feel that expected revenues from current taxes will be sufficient at least until June 30, 1957 and that under the circumstances the two million dollars expected to be raised by this business payroll tax will not be needed. Be that as it may, the proposal itself is worth review. This business payroll tax is a completely new kind of tax. It is imposed on the employer. The rate of ½ of 1% is applied to wages paid by the employer in excess of $50,000 per year. This is neither a corporation income tax nor is it an individual income tax withheld by the employer. In its effect it is similar to the State Unemployment Insurance tax in that it is levied at a specified rate on wages paid by the employer and is the expense of the employer. However, unlike the State Unemployment Insurance tax, the revenues derived from this measure are for general rather than specific purposes.

It will be interesting to see whether this proposal will be attractive to any other taxing authorities. ☆

OASI costs much higher than predicted 20 years ago

MORE THAN 100 appearances were made before the Senate Finance Committee when it held public hearings on HR 7725, the bill to liberalize social security benefits.

Of all these appearances one paragraph introduced among the comments of W. Rulon Williamson, who for 10 years was actuarial consultant to the Social Security Board, bears repetition. We quote:

"It is impossible to foretell costs either absolutely or relatively. But the 1955 outlay was more than 5 times that set down in 1935 as the expected 1955 burden, the proportion of aid from interest was less than expected, the prospective upthrust much more serious. It would seem that the method of presenting potential costs is subject to giving an unwarranted assumption of definiteness as to 'the road ahead', minimizing the seriousness of bequeathing great liabilities instead of great assets. The unfairness to our future citizens must bring some sort of reaction, if those citizens have any grasp of what we are doing to them." ☆

Maryland excludes supplemental benefits

THE Maryland Unemployment Compensation Law as amended, effective June 1, 1956, provides for the specific exclusion from the definition of wages of supplemental unemployment benefits paid by an employer to a plan or system. Thus, such payments will neither be subject to unemployment contributions, nor will the supplemental benefits cause loss of state benefits. ☆

Virginia adds many firms to unemployment tax rolls

IN VIRGINIA effective January 1, 1956, an employer of four or more individuals for 20 weeks within the current or preceding year, but not prior to 1956, is liable for state unemployment contributions. Before 1956 employers were liable when eight employees were employed 20 weeks. The definition of "wages" was changed to include supplemental unemployment benefits under any private plan financed in whole or in part by an employer.

An employer may now qualify for a reduced rate after his account has been chargeable with benefit wages for one year; formerly it was three years. Also, benefit wages include up to $2,016 of base period wages; this was formerly $1,536.

Benefits payable to claimants will range from $8 to $28 for a duration of 8-18 weeks. This was changed from $6 to $24 for a duration of 6-16 weeks.

The disqualification for misconduct and refusal of suitable employment was increased to range from 7-11 weeks. This formerly was 5-9 and 6-9 weeks respectively. Voluntary quit disqualifications were increased from five weeks to seven weeks. ☆

New decisions

Privately endowed library may elect social security coverage. A library organized with private funds as a nonprofit membership corporation and receiving 2/3rds of its income from the city is not considered a wholly owned instrumentality of the state for purposes of the social security act. A waiver certificate filed to elect coverage for its employees will not be rendered ineffective even if the employees participate in the city's retirement system. *Rev. Rul.* 56-88. On the other hand, a nonstock library corporation organized under the charter of a city, and managed by a board appointed by the city and county officials, is a wholly owned instrumentality and its employees are excepted from coverage. *Rev. Rul.* 56-89.

Summer music camp qualifies as a school. A summer music camp, exempt from income tax under Sec. 501 (c) (3), which offers regular courses of instruction in music and various other arts qualifies as a "school, college, or university" under the social security act. Services performed for it by its students who are enrolled and are regularly attending classes are excepted from "employment" for social security coverage. *Rev. Rul.* 56-87.

Parsonage not subject to social security tax. A duly ordained minister who elects social security coverage should exclude from his self employment earnings the value of a home furnished him, or the cash rental allowance in lieu of a home *Rev. Rul.* 56-85.

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TAX ASPECTS OF ESTATE PLANNING

Estate & gift taxation

OF INTEREST TO TAX PRACTIONERS

Joint tenancy may be more useful for tax purposes under new Code and inflation

THE QUESTION OF whether people should put title to their property in joint tenancy is generally answered in the negative. But the new Code, the intent of the survivor as to property disposition, and creeping inflation call for a new look at the question. Paul E. Basye, San Francisco attorney, reappraised the desirability of joint tenancy in 30 *Journal of the State Bar of California* 504. We thought his discussion was of substantial timely interest, so we obtained permission to present the following applicable quotation:

Gift taxes applicable to joint tenancies

It has become quite common for many husbands and wives to take title to property in joint tenancy. It comes as a distinct shock to learn that a gift tax may be incurred when the consideration is furnished by one of them alone. The very creation of a joint tenancy out of separate property effects a transfer of property to the other spouse and constitutes a gift. Prior to the Revenue Act of 1954 this was clearly the case, although a marital deduction has been available since 1948. Under the Revenue Act of 1954, however, the creation of a joint tenancy as between husband and wife in *real property* is not treated as a gift for federal gift-tax purposes, regardless of the amount or proportion of the consideration furnished by that spouse, unless the donor elects to treat it as a gift. A gift tax accrues only upon the termination of such joint tenancy, other than by death, to the extent of the proceeds retained by the non-contributing spouse.

Joint tenancies between husbands and wives are frequently converted into tenancies in common or community property. No gift-tax liability attaches to these conversions.[1] The value of the interests of each spouse is just the same before the conversion as afterwards. Similarly no gift-tax liability is incurred by converting tenancies in common or community property into joint tenancies.

Estate taxes applicable to joint tenancies

Under the federal estate-tax law, joint tenancies are taxed on the death of one tenant on what might be characterized as the "contribution theory." That is, the entire value of the joint tenancy property is included in the gross estate less that portion which originally belonged to the survivor and was not acquired from the deceased tenant for less than adequate and full consideration in money or money's worth. Thus joint tenancy property having its origin in the separate property of the decedent is included in his gross estate. The marital deduction is available, however, if the surviving joint tenant is the spouse of the decedent.

On the other hand, joint-tenancy property originating in the separate property of the survivor is not included in the gross estate of the decedent, because no contribution was made by him to the creation of the joint tenancy.

Joint-tenancy property held by husband and wife originating in community property presents some special problems. The marital deduction is applicable to joint tenancies held by husband and wife. Under the Revenue Act of 1948 only a decedent's interest in community property is included in his gross estate. Also under this same act a marital deduction is available up to one-half of the decedent's adjusted gross estate passing to his surviving spouse. Since the purpose of the marital deduction is to give people in non-community-property states the same treatment that is available in community-property states, it would be an anomaly if both a marital deduction and also a community-property exclusion were available. Nevertheless, there is one situation in which this is possible. If community property was converted into joint tenancy property before 1942, each joint tenant is treated as having contributed one-half to the joint tenancy; therefore only one-half of the value of the joint-tenancy property is included in the gross estate of the deceased spouse. But the marital deduction is also available to the surviving spouse with respect to that same one-half. This gives rise to the three-quarters—one-quarter rule with the astounding result that only one-fourth of the joint-tenancy property is taxed. However, if the conversion was made after 1941, the joint-tenancy property having its origin in community property is treated as community property, with the result that although only one-half is includible in the gross estate, the marital deduction is not available.

Income taxes applicable to joint tenancies

For income-tax purposes joint tenants, whether related by marriage or not, are treated as equal co-owners of joint tenancy property. Each must report his proportionate part of the income received from the property.

The most important aspect of joint-tenancy property insofar as income taxes apply is its cost basis in determining gain or loss on disposition after the death of one of the tenants. It is well known, of course, that the separate property of a decedent acquires a new basis upon his death which is entirely independent of its original cost or other basis. Similarly, all the community property of a husband and wife, and not merely the decedent's half, acquires a new basis upon the death of either. The very opposite rule has applied in the case of joint tenancy property. Prior to the Revenue Act of 1954 the basis of joint-tenancy property for determining gain or loss on its subsequent disposition was unaffected by the death of one of the joint tenants. Since each tenant has always been regarded as having been seised of the whole, his original basis continued

[1] *Sullivan's Estate* v. *Commissioner*, 175 F. 2d 657 (C.A. 9th, 1949); *Rickenberg* v. *Commissioner*, 177 F. 2d 114 (C.A.-9 1949), *cert. den.* 338 U.S. 949. There is one important exception to this statement since the Revenue Act of 1954. If a tax-free joint tenancy were created by husband and wife in real property for which the consideration was furnished by one spouse alone, its subsequent conversion into a tenancy in common or community property would result in a taxable gift under IRC Section 2515(b) because of its termination other than by death and the retention by the non-contributing spouse of more than his contribution.

for the entire property. This was no more than a logical application of feudal property law, although it resulted in striking inequities when compared to property held as community property or as tenancy in common at the date of death. Where property has a higher value at death than its original cost, ownership by the community has clearly been the most advantageous form, with tenancy in common taking second place and joint tenancy the least desirable. If values have depreciated during the period of holding, joint tenancy is clearly the most advantageous form of ownership. With inflation continuing almost unabated, onwership in joint tenancy has become the least desirable for income-tax purposes in computing capital gains.

Some relief has been provided under the Revenue Act of 1954. With respect to decedents dying after 1953 a new basis is provided for joint-tenancy property to the extent that any contributed portion of or interest in such property is included in the gross estate of the deceased joint tenant for federal estate-tax purposes. This new basis is the value at death of that portion of the joint tenancy property which is included in the gross estate of the deceased joint tenant, plus the old basis of the remaining portion. In effect, there is a theoretical partition of the property at death based upon the individual contributions of the joint tenants to the end that the share of the deceased joint tenant is given a new basis. For example, if the deceased joint tenant had contributed the entire purchase price of the property, it is entirely included in his estate and therefore all of it acquires a new basis. Or if both tenants contributed equally to the purchase of point-tenancy property, or if community funds were used in its purchase, only one-half receives a new basis and the original basis of the other half continues.

Advantages under inflation

Thus, if we are still in a period of inflation, and property has appreciated between the date of acquisition and the date of death, assuming that property is acquired with community funds, its ownership by husband and wife as community property remains preferable to their ownership in joint tenancy, because the entire community property acquires a stepped-up basis, whereas only one-half of joint tenancy property acquires a stepped-up basis.

It should be kept in mind that the foregoing discussion assumes that the surviving joint tenant makes a sale or other disposition of the property. Much of the argument of estate-planning analysis which discourages ownership in joint-tenancy form assumes that the surviving joint tenant will make such a sale. In recommending one form of concurrent ownership over another, the intention and probable plan of spouses in relation to a particular piece of property and the possible income taxes resulting from a sale or other disposition should be weighed against the combined effect of estate and inheritance taxes, gift taxes, and the expenses of probate and administration. Although joint tenancies are still at a tax disadvantage in the case of valuable property, at least some of the inequitable tax treatment has been ameliorated. ☆

New estate & gift decisions this month

Property previously taxed is net after estate tax paid by heir. Taxpayer-estate claimed a deduction for property previously taxed. The property was certain shares of stock received by the decedent from her father. In 1931 he had made her a joint owner but the property was included in his estate upon his death in 1947. The daughter had paid her share of the tax on the father's estate. The Commissioner argued that the property was not properly includible in the father's estate, a gift having been made in 1931. The court upholds the taxpayer on this point, but the credit is allowable for the net value of the property received from the previous estate, therefore the estate tax paid by the daughter must be deducted. *Plessen Estate,* 25 TC No. 155.

Estate-tax refund claim need not ask for attorneys' fees in connection with it. The executors filed a claim for refund based on the erroneous inclusion in the gross estate of the proceeds of an insurance policy. No specific claim was made for a deduction on account of attorneys' fees to be paid if a suit for refund should prove necessary. However, when suit was actually commenced in the district court the executors specifically requested allowance of a deduction for attorneys' fees. The court held this was sufficient compliance with the Regulations. The general rule stated in the Regulations is that each ground for refund must be stated in the claim. However, there is a specific provision that attorneys' fees in connection with the prosecution of a refund claim shall be claimed when the deficiency is contested or refund claim prosecuted. *Bohner Estate,* CA-7, 4/10/56.

Estate tax lien on property is divested by sale to bona fide purchaser. A surviving joint tenant is personally liable for the estate tax on the jointly-owned property, and the government has a lien on the property to the extent of the tax. However, the Code provides that this lien is divested by a sale to a bona fide purchaser for a full consideration, even though the purchaser is presumed to know of the lien. The lien then attaches to the other property of the surviving joint tenant. *Rev. Rul.* 56-144.

Grantor estate includes transfer in trust (he retained a life interest) less life interest given spouse. Decedent and his wife as settlors transferred certain property to an irrevocable trust, each to receive one-half of the income, with the entire income to the survivor for life. The remainder at the death of the surviving settlor was to go to their children. In effect the decedent made a transfer by which he gave a remainder interest to children, a life interest in half to his wife, and retained a life interest for himself in half. If there were any doubt that this property is includible in his estate because he retained an interest "for a period, not ascertainable without reference to his death," as specified in the Code, the doubt is dispelled by the committee reports on the Technical Changes Act of 1949. The value of the property, less the value of the wife's life interest, is includible in the estate. As the estate was not large enough to pay the expenses and taxes, the trust advanced funds to the estate sufficient to leave a sum for distribution to the widow. This distribution was not from assets received from the decedent and was not allowable for the marital deduction. *Hohensee Estate,* 25 TC No. 148.

No estate tax on executive's deferred-compensation contract; it had no market value. Decedent was executive head of Gimbel's department store when he

died suddenly at the age of 52. He was working under a written contract of employment, originally for a year, extended on a month-to-month basis. Under the contract he was entitled to contingent payments of $6,000 a year for 15 years (in addition to his salary of $50.000). The contingent payments would be forfeited if he worked for a competitor, etc. The Commissioner included in his gross estate the present value of the right to receive $6,000 a year for fifteen years. This the court holds was error. Several dealers in remainders and future interests testified that immediately prior to decedent's death the contracts had no fair market value—he might act in a way to forfeit the right, and considering his age, ability, and earning power it was not at all unlikely that he would. The Commissioner would be correct only if the estate is valued as of the moment succeeding death, when the possibility ceased, but it is not so valued. *Blum Estate (Goodman, Exec.)*, DC Pa.

Survivorship annuity valued as of husband's death; thus not reduced by decedent's expectancy. Decedent was employed by the Metropolitan Life Insurance Company. As part of a group plan he was issued an annuity providing for retirement income to himself and survivorship benefits to his wife and son. Decedent died in 1944. Since it was not mentioned in the refund claims the executor could not contest the taxability of the annuity, under the 1939 Code, under the *Higgs* case (184 F. 2d 427). (The court held there that a wife's annuity was not taxable in the husband's estate.) It had been purchased by the employer and decedent made no transfer respecting it. The court held this annuity was to be valued on the basis of corresponding annuities issued by Metropolitan based on the age of the widow at the time of death. It rejected the estate's argument that valuation should be made at the instant before death and thus reduced by virtue of decedent's then life expectancy. The transfer being taxed does not come in existence until death occurs. *Christiernin Estate*, DC NJ, 3/2/56.

$10,000 promised to confidential employee allowed as estate-tax deduction. Decedent, an elderly widow, had been executrix of her husband's estate. Surcharge proceedings had been brought against her and she felt her best witness would be her long-time confidential secretary, who had also worked for her husband. Decedent promised her $10,000 for her work on this matter if she would stay in her employ. After decedent's death her daughter paid the $10,000. The court allows it as a liability. Prepaid fire-insurance premiums on rental property of the decedent are an estate asset. Their expiration and other expenses related to this property are not allowable as an administration expense in the absence of proof they were not a cost of producing income. The proper deduction for liability of surcharge is also determined by the court. *Reeves*, TCM 1956-69.

Widow's agreement to take weekly sum from testamentary trust a terminable interest. Decedent bequeathed his widow a life estate in two pieces of real property and named her as one of the beneficiaries of a trust. However the trustees were given absolute discretion as to the amounts of principal and income to be distributed and the beneficiaries to whom to pay it. She entered into an agreement with the trustees to accept $50 a week for life. The court holds the agreement was not renunciation of the will and an election to take dower; nor was it a purchase by the trustees of her dower rights. The payments she was to receive were in effect provided by the decedent's will: the trustees merely agreed to exercise their discretion in this way. Her interest was therefore only for life and as such terminable and not includible for the marital deduction. *Kleinman*, 25 TC No. 146.

Gift of foreign land taxable. Although the estate tax specifically exempts real property situated outside the United States, and the gift tax is generally held to be complementary to the estate tax, it does not follow that Congress intended to exempt gifts of such property from the gift tax. Instead, the court finds the failure to provide specifically for such exemption was purposeful. The gift of Canadian land to the taxpayer's sons is taxable. *MacDonald*, DC Mass., 3/27/56.

State law gives property to widow indefeasibly; it therefore qualifies for marital deduction. Decedent bequeathed one-third of his estate to his wife "if living at the time of the distribution of my estate." After hearing the testimony of several attorneys who were experts in the applicable South Dakota law, the court concluded that this was equivalent to a bequest to the wife "if living at the time of my death." It thus created an indefeasibly vested interest qualifying for the marital deduction. The court was also influenced by the fact that the decedent, an eminent lawyer, made the will shortly after the enactment of the Revenue Act of 1948 and obviously intended the bequest to qualify for the marital deduction newly-provided by that act. *Kellar Estate*, DC S. Dak., 2/28/56.

Marital deduction for joint property; will didn't make interest terminable. Decedent and his wife had executed a joint and mutual will which, under the applicable Nebraska law, would limit the survivor's interest in property passing at death to a life estate with limited power to invade. The Commissioner argued that the effect of this will was to convert joint-tenancy property, in which the survivor would otherwise enjoy full ownership, into a terminable interest not qualifying for the marital deduction. But the court determined that the will had no effect on the joint-tenancy property; the survivor had complete ownership. He had the right to dispose of the property though he might be liable for breach of the contract to leave it as set out in the will. The marital deduction is allowable. *Peterson Estate*, CA-8, 10/11/55.

Estate taxable on only one-half of income from community property. [*Acquiescence.*] Taxpayer was the estate of a Texan who had died owning property in community with his wife. The Tax Court held the estate taxable on only half of the income which arose from the community property during adminstration. *Woodward Estate (Barnhill, Exec.)*, 24 TC No. 95, *acq.* IRB 1955-10.

No additional gift exclusion for gift to donees jointly after gifts to same donees separately. In 1951 taxpayer made separate gifts to his son and his son's wife. In reporting these gifts, the donor claimed two annual exclusions of $3,000 each. During the same year he made a further gift to them jointly and deducted a third annual exclusion of $3,000. The court holds that even though under local law the joint gift created in the donees an estate of entirety, the latter was not a separate entity for gift tax. The third annual exclusion is disallowed. *Buder Estate*, 25 TC No. 112.

NEW DEVELOPMENTS IN

Taxation of oil & gas

EDITED BY GODFREY WM. WELSCH, LL.B., CPA

Effort being made to limit capital gains treatment on oil, gas, other mineral payments

A BLOW to some of the advantageous capital-gains treatment now afforded oil, gas, and other mineral payments appears in HR 9559, introduced recently by Representative Wilbur Mills. The proposal covers many matters of importance to the oil industry; it should be read thoroughly and analyzed to determine effects on oil operations.

Mr. Mills says the proposal has a two-fold purpose: (1) to change the tax treatment of sales, exchanges, transfers and gifts of oil, gas, and production payments; and (2) to restore the 1939 Code rules for determining oil and gas property interests.

The primary purpose of the bill is to prevent proceeds from sales of oil, gas, and other mineral payments from receiving capital-gains treatment. The bill is intended to overrule recent court decisions which have held that oil and other mineral payments are property interests like royalty and operating interests, and, therefore, are entitled to the same tax treatment upon their sale. Under these decisions, taxpayers owning royalty or operating interests in natural resources, such as oil, can convert ordinary income into capital gains by periodically selling oil payments from their royalty or operating interests. The effect of the bill is to treat the sale of oil, gas, and production payments as the sale of income and not the sale of an interest in property.

However, this general rule is not to apply to transfers of oil or other payments where the proceeds received are pledged for use in the development of the property from which payment is carved; nor does the rule apply where an oil or other payment is conveyed in return for services or materials used in the development of the property. This exception is intended to preserve the *status quo* with respect to the development of mineral leases by joint ventures. It has long been settled that assignments of interests in minerals prior to production, whether in the form of a mineral payment or a royalty interest, in return for money, services, or materials pledged for development of the property is not a taxable exchange on the theory there is an implied trust or agency that the consideration received is to be used for exploration and development of the property and not for the personal use of the owner of the lease.

Royalties not affected

Oil payments and other mineral payments are distinguishable from royalty and operating rights in that the latter interests extend to the entire oil or mineral resources and as such represent fractional forms of property rights; whereas, oil payments and other mineral payments are a right to income from a royalty or operating interest for a limited time or amount. This bill does not change the tax treatment of royalty or operating interests. Under the bill, the term "production payments" includes sulphur payments, carved-out ore payments and "term royalties" (a royalty interest for a term of years) but is not intended to cover entire royalty or operating interests which revert to the landowner if there is no production.

In order to conform to the general rule treating mineral payments as income, the provision relating to nontaxable exchanges of similar income-producing property (Section 1031) is made inapplicable under the bill to exchanges of oil and similar payments. Consequently, an exchange of an oil payment for income-producing real estate, such as a ranch, would be taxed like a sale. This general rule is also made applicable to transfers of oil and similar payments to and from corporations. Thus, a corporation cannot declare a dividend of an oil payment and avoid taxation on its royalty income; nor can a high-bracket taxpayer transfer an oil payment to a lower-bracket corporation and avoid taxation on his royalty income.

Additionally, the income status of oil and similar payments is extended under the bill to gifts. Thus, the donor of an oil payment is taxed as the oil income is produced even though such income is received by the recipient of the payment. However, an exception is provided where a taxpayer transfers an oil or similar payment to a charity and such payment is payable for at least two years. Additionally, where the donor to a charity of an oil or other payment retains an interest in the underlying royalty or operating interest, which is worth more than 5 per cent of the transferred payment, the donor will not be permitted to deduct the value of the payment as a charitable deduction. The charitable deduction provisions in the bill are consistent with provisions relating to charitable deductions of two-year Clifford-type trusts in the Code (Sections 170(b)(1)(D) and 673(b)). They are intended to overrule recent court decisions whereby taxpayers have, in effect, obtained double deductions by transferring short-term oil payments. The double deduction results because donors have avoided paying a tax on the mineral income transferred and at the same time have obtained a charitable deduction for the value of the transferred income.

The provisions of the bill relating to oil, gas, and production payments are applicable to transactions consummated after February 27, 1956.

The second portion of this bill is intended to eliminate the application of the property aggregation rules under Section 614 of the 1954 Internal Revenue Code to oil and gas interests and to reestablish the oil and gas property rules as they were under the 1939 Code. It is understood that these property aggregation rules were intended to cover problems peculiar to the mining industry. However, they cover all natural resources taxed under the 1954 Code.

The provisions of the bill restoring the 1939 Code rules determining oil and gas property apply to taxable years beginning after December 31, 1955, except that taxpayers may elect within 90 days after the enactment of the bill to apply these rules retroactively to all years covered by the 1954 Code. ☆

CORPORATE & PERSONAL PROBLEMS IN

Taxation of compensation

EDITED BY JOHN P. ALLISON, LL.B.

Entertainment expenses, deferred pay, fringe benefits discussed at AIA conference

WE WENT to the American Institute of Accountants' conference on tax planning for business executives last fall, and came away feeling we'd gotten lots of good information. We've just now found space to pass on what we picked up there. Panelist Matthew F. Blake (of Pogson, Peloubet & Co., New York) asked pertinent questions, and moderator Leslie Mills (of Price Waterhouse) gave useful answers. Samples:

Travel, entertainment expenses

Question: *We all know that business executives must entertain customers. How can we protect these executives—and their companies, for that matter—from disallowances by internal revenue agents?*

Answer: There is a slight conflict of interest here between the company and the employee. For the employee, the best arrangement is to have the company pay the bills directly or to reimburse for itemized expenses. Companies dislike this as a general rule, however, for two reasons. One is that there is much bookkeeping involved, and the second is that you tend to lose control of the total amount of money expended by the individual. Companies usually prefer that lump-sum expense advances be made to their employees. This, is, however, considerably weaker from the employee's point of view because he has no excuse for eliminating this lump-sum amount from his gross income on his personal tax return. He has to keep detailed records and be able to support the deductions at the time his return is examined. Then, of course, the other method is for the individual not to request any reimbursement from the company but to claim a deduction on his tax return.

Question: *Does not a problem develop if the employee does not claim reimbursement from the company but deducts expenses on 'his own return? I should think that would imply that he is in business.*

Answer: That plan gives the most difficulty. First, you must prove that your compensation arrangement contemplates that you will spend certain amounts out of your salary which will not be reimbursed. The law on the subject is that the company's expenses are not yours and you are not allowed to deduct them. Another difficulty would be the same as we had on the lump-sum advance; that it, showing the money was spent for business purposes, the question of proof, reasonableness, and so forth.

Deferring pay via pension plans

Question: *There are many ways sanctioned by the law to spread taxability of compensation over future years, to and beyond retirement. Here we deal with very complicated provisions of the law and new wrinkles and developments always come up. However, the focal point usually is the pension plan. There is an almost infinite variety of pension plans, but everyone will probably be interested in this question: Having in mind the new statutory provisions, what changes in existing pension plans would you recommend to make sure that the employee receives capital-gain benefit when he retires or dies?*

Answer: The law as it is now drawn makes it possible for the members to obtain long-term capital-gain benefits on the amounts contributed by the company in two situations. One is where an employee, upon separation from employment or when he becomes a pensioner, withdraws his entire interest in the plan in the form of cash or property (as distinguished from receiving an annuity policy) within a year. Here his share is treated as a long-term capital gain. This provision was with us before, but the 1954 Code made a liberalization. Where a pensioner dies before receiving the full amount of his benefits, long-term capital-gain treatment can be obtained by his personal representatives if they withdraw everything he was entitled to receive within a year's time. Such action also could affect the $5,000 death benefit. I think it is important to review pension plans every year as a matter of routine, and these two particular advantages should be introduced as features of every pension and profit-sharing plan.

Question: *I have a question on the investment of the fund of the pension plan trust. Suppose they invest in tax-exempt securities. Would this exemption carry over to the payments to the employees?*

Answer: No, the income loses its identity in the trust, just as though it were a dividend paid by a corporation out of tax-exempt income.

Question: *If you are trustee of a pension plan and the employer suggested that you use plan money to erect a building which he would lease from the plan, what tax problems would you face as trustee?*

Answer: That problem is coming up very often in practice today. I would recommend strongly that an advance ruling be obtained on any transactions between the trust and the company. The case you mentioned of the trust putting up a building to be leased to the employer company, for instance, presents these difficulties. If the rent is set too low, the examining revenue agent may say that it is a "prohibited transaction" because you are taking advantage of your close relationship with the fund, and the trust or fund could well lose its exemption. On the other hand, if the rent were set too high, the government may claim that you are attempting to circumvent the limits on the amount of contributions established for the employer.

Question: *Would these comments apply to almost any other business transaction between trust and employer?*

Answer: Yes. There is another facet of that problem. The income from the rent of real estate would not be taxable, but if you changed the facts a little and rented a piece of machinery or a steamship, the income *could* be taxable to the trust if such rental constituted engaging in a business. Even with respect to the real estate, the trust could lose its tax-exempt status to some extent if it bor-

rowed money in order to finance the purchase. Again it is suggested that you obtain an advance ruling if you meet these situations.

New: stock-saving plans

Question: There is a relatively new wrinkle developing in the profit-sharing field which is called thrift or stock-saving plans. I wish you would tell us briefly how these plans operate.

Answer: The advantages of profit-sharing and pension plans stem basically from the fact that they can be made tax-exempt. Here is a form of savings plan for employees which is catching on because it also may be made tax-exempt. The usual arrangement is to set certain limits within which employees may save in a fund; the employer agrees to match or pay a certain percentage of the employee's savings into the fund; an individual account is kept for each employee. Neither the income of the fund nor the contribution of the employer constitutes taxable income to the employee until withdrawn.

Question: If he is not taxed until he makes withdrawals, what kind of income does he have when he does draw it out?

Answer: He will have ordinary income unless the withdrawal relates to his departure from the company. In that event he would have the same capital-gain privilege available under a profit-sharing or pension plan.

Question: Suppose the fund follows the practice of buying stock of the employer. By the time the employee draws that out, it has appreciated in value. When is the appreciation taxed?

Answer: Let us assume that at the employee's direction the fund bought for himself a share of his employer's stock at $10. At the time that he takes it out in kind, it is worth $25. The $15 is not taxable to him at that time. However, the $10 a share remains as his cost when and if he sells the stock.

Question: What benefit does the split-dollar life insurance, in which cash-surrender value goes to the employer, give over the usual group term life insurance in whcih no tax is incurred and all the proceeds go to the employee's dependents? (Asked by a registrant, answered by J. S. Seidman.)

Answer: Group policies usually are extended on a company-wide basis, whereas a split-dollar plan can be limited to a relatively small group. A split-dollar plan is less costly than group coverage because the employer gets its money back, and the only loss is interest on the money advanced to finance cash surrender value. Further, this is a standard type of insurance policy which can be taken over by the employee at such time as he can afford it, or when he leaves the company, whereas group insurance represents merely renewable term coverage with no cash or loan value. When the employee takes over the policy he probably will be able to borrow sufficient money against the cash value to effect the purchase from his company. ☆

Pension, profit-sharing trusts most expensive to administer

THE FEDERAL RESERVE BANK has reported that pension and profit-sharing trusts are the most expensive to operate. Its figures show that in 1954 nine New York City banks, which probably hold about 60% of all such funds held by trustees in the entire country, had a net operating loss before income taxes of $81,300. The expenses of servicing these trusts, stated as a percentage of total commissions and fees, were larger than for any other type of trust. Nearly 80% of the commissions and fees in these accounts are absorbed by salaries and expenses related to salaries. Says the Reserve: "The high expense ratio . . . may indicate that the level of income from such trusts is low." ☆

New compensation decisions this month

Annuity for foreign service may be excluded from income under 1939 Code. For years after 1950, a resident is not taxed on income received in the U. S. applicable to service while a resident abroad. The Service holds that distributions under an employees' funded pension or annuity plan in a taxable year of a resident citizen-beneficiary beginning after 12/31/50 and ending before 8/17/54, on account of the employer's contributions to the fund for his personal services rendered outside the U. S. as a bona fide foreign resident for an uninterrupted period including an entire taxable year, may be considered as earned income from foreign sources. However, that portion of the annuity payments which represents the earnings on, or accretions to, contributions of either employer or employee is not to be so excluded. [The new rules on taxation of annuities apply to years after 1954. *Ed.*] *Rev. Rul.* 56-125.

Compensation for obtaining purchaser of a business held ordinary income. Taxpayer, general manager of a bottling company in Arcadia, California, cancelled his contract giving him an option to buy the business and agreed that he would receive $70,000 if he obtained a purchaser for the business willing to pay a certain price. He performed his part of the agreement and reported the $70,000 received as capital gain. The court, in an extremely brief finding of fact and conclusion of law, refuses to upset the Commissioner's determination of ordinary income treatment in the absence of proof that taxpayer had sold or exchanged a capital asset. *Culley,* DC Calif., 3/21/56.

Investment cost of annuities for foreign service. The IRS clarifies its position on the way a U. S. resident should compute his investment as of January 1, 1954, in an annuity contract to which contributions were made by his employers for services rendered abroad. Prior to the *Crispin* case (200 F.2d 99) in 1952, the Service had held that a U. S. resident was taxable on 3% of the contributions he had made directly until he recovered his own cost, thereafter he would be taxable on the full annual payment. He could not recover tax-free the contributions made by his employers which were not taxable to him because made while the employee served abroad. The *Crispin* case held that the employer's contribution is part of the employee's cost, it being irrelevant that the contribution was tax-exempt as foreign earnings. The Service now holds that in computing his investment at January 1, 1954, the employee may treat as recovered cost only the portion of the annual payments actually excluded from his income under the Treasury rules at the time. He will not be required to treat as recovered amounts on which he paid a tax. *Rev. Rul.* 56-123.

Annuity distributed by liquidating pension trust no longer exempt is taxable. In 1948, taxpayer received an annuity purchased for him by the trustees in

winding up the bonus and profit-sharing trust of a dissolved employer. They used the credits in his account, based on contributions made in 1942 and 1943 when the trust was exempt. However, the trust was not exempt in 1948, due to changes in the law. The Tax Court held that, not coming under the exemption provision of the law, the receipt of the annuity contract represented a income to the extent of its fair market value. This court affirms. *Einstein,* CA-6, 2/24/56.

Janitor's use of apartment taxable as compensation (old law). Taxpayer, a janitor, received a rent-free apartment in consideration for his services. The year involved was 1951, and the Commissioner was applying Mimeo. 6472, holding that lodging is taxable if in fact compensatory. The court agreed; taxpayer and his wife performed substantial services and their only recompense was this apartment. Clearly it was compensation. [Note: Under the present Code, the value of lodging is nontaxable if the employee is required to accept it. *Ed.*] *Dietz,* 25 TC No. 147.

Esso's sick-benefit plan fails to qualify as "health insurance" (old law). Section 22(b)(5) of the 1939 Code permitted an exclusion from gross income for amounts received through "accident or health insurance." The phrase "health insurance" is here held limited in reference to ordinary commercial types of insurance policies and not applicable to amounts received by taxpayer, an Esso employee, under the company's sickness-benefit plan. The payments were related to length of service and were not dependent in any way upon the degree or extent of the employee's illness. The court notes that other courts have upheld company sick-pay plans as health insurance: *Epmeier,* 199 F.2d 508 (CA-7), *Haynes,* DC Ga., 1/28/55, *Herbkersman,* DC Ohio 8/1/55. Two judges dissent; they would follow *Epmeier.* [Under the 1954 Code the $100 a week exclusion is allowable for sick pay paid under a formal or informal employer-employee plan. *Ed.*] *Oliva,* 25 TC No. 153.

Severance pay on going out of business not "back pay." A lump-sum payment received by an employee upon discontinuance of his employer's business, made in accordance with a union agreement and representing severance pay, two-weeks'-notice pay, and accrued vacation pay, does not qualify for the special "back pay" treatment. The back-pay provisions apply only to compensation which would have been paid in prior years except for bankruptcy, a dispute, or similar occurrence. *Rev. Rul.* 56-108.

Inventor's work begins with action to perfect idea. Taxpayer, an inventor of an air-flow-operated economizer for aircraft power plant carburetors, claimed the benefits of Section 107 of the 1939 Code, contending that the work performed on his invention covered a period of 36 months commencing prior to February 1936. The evidence showed that the taxpayer thought about and discussed the problem covered by his invention as early as 1935, but did not reduce anything to writing until April, 1936. No "work," within the meaning of the statute, was done, according to the court, until the latter date, and the taxpayer did not qualify for Section 107 treatment. *Beardsley,* DC Conn., 1/14/56.

Part-time geological engineer is independent contractor. A part-time geological engineer who operates from his home and undertakes on a fee basis specific assignments in geological engineering work and special geological research during evenings and weekends is engaged in a "trade or business" and must report such fees in computing net earnings from self-employment. *Rev. Rul.* 56-132. ***See Blum estate case,*** reported in the Estate & Gift department of this issue, page 369, for tax treatment of employee's deferred compensation contract at his death.

New partnership decisions this month

Partnership dividing foreign and domestic income in different ratios held two partnerships (old law). Partners doing business in the U. S. and a foreign country have different shares in profits from domestic branches. The Service holds there are two partnerships, rather than one, for federal income-tax purposes. This applies to the 1939 Code. The distinction between one and two partnerships would be significant in the case of a nonresident alien partner taxable on income from U. S. sources only. If there were but one partnership, the foreign income allocable to him would be determined by his over-all profit share. [Under the 1954 Code, allocation of items of income and expense may be specified by the agreement. *Ed.*] *Rev. Rul.* 56-134.

"Rental" payments to partner's widow really purchase of her interest. Under decedent's will his executrix was entitled to continue as partner in an automobile agency which held a Buick franchise. Because Buick refused to reissue a franchise for use in a partnership of which an estate was a member, the executrix entered into an agreement with the remaining partners to (1) sell the estate's interest in the partnership for $50,000; (2) receive title to the agency premises which she was to lease back to a new partnership of the remaining partners for a percentage of profits; (3) convey back title to the agency premises at the end of one year. The payments under this one-year "lease" are held to have been made for the purchase of the executrix's right to become and continue indefinitely as a member of the old partnership; the remaining partners could not treat the payments as a distribution of firm profits. [This would have reduced the profit taxable to them. *Ed.*] *McKelvey,* TCM 1956-70.

Father did not intend to join with minor son as business partner. A licensed hog dealer entered into a written partnership agreement with his wife in January 1941 upon her investment of $5,000. At the end of that year, the wife assigned her partnership interest, with her husband's consent, to their three-year-old son. The court finds that the father's only purpose in setting up the partnership arrangement was to provide for his son's financial security, not to make him a real business partner. All income is, therefore taxable to father. *Sparks,* TCM 1956-71.

Family partnership in farm found valid. The court, in a brief finding of fact and opinion, finds taxpayer, his wife, and his son were partners in the operation of the farm. The motive was both to save taxes and to encourage the interest of the school-age son in farming. *Batman,* DC Tex., 1/24/56.

THE TAXATION OF INDIVIDUALS

Personal tax problems

EDITED BY BENJAMIN HARROW, J.D., CPA

Services rendered, not donative intent, governs exemption of study grants

by JOHN C. CHOMMIE

The 1954 Code seems to have the effect of turning every college treasurer and registrar into a part-time tax expert, what with constant pleas for help from students wanting to take advantage of the new Code's liberalized treatment of study grants and scholarships. We asked Mr. Chommie, who has investigated this field rather thoroughly, to give us a practical outline of who is and who isn't taxed. Here is his advice, including comments on the always-troublesome borderline cases which cause practitioners lots of work.

GIFTS HAVE BEEN EXCLUDED from the concept of taxable income since the first revenue act under the Sixteenth Amendment. Congress, however, has been far from articulate in justifying the exclusion of such economic benefits. Presumably the rationale is in part the undesirability of taxing mere allocations of wealth within the family, though the statute has not in terms been so limited. The result has been considerable uncertainty as to tax consequences of non-family transactions alleged to be gifts. Sharing the uncertainty have been payments to students and research scholars characterized as scholarships and fellowships. These transactions have often demanded a detailed scrutiny of the conditions of each grant and surrounding circumstances in a search for an illusive donative intent.[1] Therefore, the asserted purpose of Section 117 of the *1954 Code* governing scholarships and fellowships was to eliminate "the existing confusion as to whether such payments are to be treated as income or as gifts."[2]

Broadly, Section 117(a) excludes from income "any amount" received as a scholarship or fellowship, and amounts received and expended for travel, research, clerical help, and equipment. Section 117(b) imposes two types of limitations on the exclusion: (1) where the recipient is a degree candidate, that portion of a payment responsive to services rendered is included in income; and (2) where the recipient is not a degree candidate the grantor must be a statutory charity or political unit, and the exclusion is limited in amount to $300 a month for 36 months.

Characterization as a gift

Can a grant of educational aid still be characterized as a gift? Nothing in the language of Section 117 nor in its legislative history demands exclusive characterization as a Section 117 transaction. Presumably a gift of educational aid can still be made. This would seem to be true particularly where a family or close personal relationship exists. And in a non-family transaction perhaps no court would go so far as to deny the possibility of a gift. Therefore it would be theoretically possible, for example, for a corporate chemist or a law firm's tax man to be granted leave and have additional formal training underwritten by the employer and characterized as a gift. However, it would be difficult to visualize a court making such a finding. Normally, the flow of indirect benefits to the payor would negative a finding of the necessary donative intent. Further, the analogy of such a payment to the occasional case where additional payments to corporate executives have been held a gift rather than additional compensation[3] would not seem to be persuasive in light of specific entry into this area by Congress with Section 117. Therefore it would seem that except in the family area, it is doubtful that a gift contention would receive serious consideration.

Scholarships

Neither "scholarship" nor "fellowship" is defined in the Code. This, however, does not seem to be a serious defect in light of the limitations imposed on both in Section 117(b). Both terms are broad enough in actual use to cover any grant-in-aid of educational training or the conducting of research where an employment relationship does not exist.

The basic requirement for the scholarship exclusion and the degree fellowship is that it be received at "an educational institution which normally maintains a regular faculty and curriculum and normally has a regularly organized body of students in attendance at the place where its educational activities are carried on."[4]

The "amount received" under both a scholarship and fellowship includes "the value of contributed services and accomodations" which is illustrated in the Senate Report as embracing such items as "room and board, and laundry services."[5] Undoubtedly it would include such an item as tuition. In this connection the Senate Report contains a statement (for which there is no express statutory authority) that where the institution participates in a faculty-child tuition-remittance plan, "the amount of tuition so remitted shall be considered to be received as a scholarship under this section."[6] Perhaps such explanation will also be effective to prevent any attempt to reach such a payment as imputed income to the father as a fringe benefit flowing from his teacher-employee status.

The scholarship exclusion is subject to both the service and the non-degree limitations noted above. Normally services are not demanded in return for a scholarship, which is usually an undergraduate grant-in-aid. Therefore, few problems are anticipated here. This would seem to be true even in case of the athletic scholarship, though the sophisticate may be skeptical here, where service on an athletic team may be an express or implied condition. It is extremely doubtful that this flow of benefits was intended to be embraced within the limits of Section 117(b)(1). In short,

there seems to be little reason in drawing a distinction between athletic and academic performance often demanded as a condition of a scholarship grant.

It should also be pointed out that Section 117(a)(2) provides that amounts received "to cover expenses for" travel, clerical help, or equipment are limited to actual expenditures for these items. These items, however, are not normally benefits received from an undergraduate scholarship.

Finally, it should be noted that Section 74 of the new Code, providing for the inclusion of prizes and awards in taxable income, expressly excludes amounts received as scholarships and fellowships under Section 117. While there was no pre-1954 law or ruling on this point, any doubts as to the taxability of scholarships awarded in a competitive contest under the *Robertson* doctrine[7] have therefore been set to rest in favor of exclusion.

Degree fellowships (and scholarships)

The degree fellowship is perhaps most often thought of in terms of a grant-in-aid of postgraduate training; perhaps as training leading to the doctorate. In actual practice the terms of such grants are apt to contain a variety of restrictions and conditions. Congress, however, has focused the exclusion limitation of Section 117(b)(1) on that portion of the "amount received which represents payment for teaching, research, or other services in the nature of part-time employment." And apparently in an effort to prevent a disruption of institutional training programs, provision is made that if such services "are required of all candidates (whether or not recipients of scholarship or fellowship grants)" they shall not be regarded as "part-time employment."

The employment limitation will undoubtedly focus attention on interpretation. In so far as this is true, it would seem that the pre-1954 case law should be of considerable aid here.

The terms of the grants are so varied that detailed discussion is prohibited in this note. Broadly, however, if the conditions of the grant demand services or research from which a benefit to an industry can be reasonably inferred, the grant may be in danger of being characterized as employment. If, as a matter of substance, a degree fellow is working to further the economic advantage of a commercial concern or group, other facts, such as performance of the work at an educational institution, selection by a school graduate committee, or the lack of direct benefit to the school, would not seem to preclude a finding of employment. Similarly, even though research fruits may flow primarily to the public, an employment relationship may be indicated by such facts as a required work week, vacation provision, tax withholding, and control of the fruits of the research by the school.

An illuminating 1939 Code decision in this respect is *Rober F. Doerge*.[8] In this case the taxpayer, a graduate candidate for the degree of doctor of philosophy, was granted fellowships starting in 1945, established at the University of Minnesota by the Minnesota Pharmaceutical Association, Lederle Laboratories, Inc., and Eli Lilly and Company. During the 1947-1948 school year, the required research "consisted of synthesizing and testing pharmacologically certain dithiobarbituric acid derivatives." For the 1948-1949 school year the University made a $1,000 grant from a noncommercial fund in continuation of the work. This required, presumably as a result of University interpretation, research in "pharmaceutical chemistry or pharmacognosy." However, general University regulations provided for a reservation of patent rights though nothing of commercial value was realized. The tax year involved was 1949 and hence the terms of the industrial grants did not come under the court's scrutiny. The payments were held to be income, largely on the basis of the requirement of full-time research services.

The *Doerge* case illustrates the possible range of inquiry under both the 1939 and 1954 Codes. It is difficult to escape the conclusion that under the 1954 Code each case will require a detailed examination of the terms of each grant for signs of employment. The fewer the restrictions from the standpoint of both founder and school, the more the likelihood that the grant will qualify for exclusion; that the principal flow of benefits is to the community, presumably the justifying rationale of Section 117. Here perhaps is to be noted a sharp contrast in theory with the pre-1954 view of the Service as regards research fellowships.[9]

The Section 117(b)(1) part-time employment limitation clearly speaks in terms of apportionment. What is the value of ten hours a week by a degree candidate in the laboratory? Or of teaching one course in Advanced Baseball? Here we may find the Commissioner, in a role quite different from the one he plays in corporate-executive-salary cases, extolling the worth of the fellow, and the taxpayer, on the other hand, playing down the value of such efforts. Establishment of a rule is hardly possible. Perhaps such factors as the nature of the work done, the previous accomplishments of the recipient, and comparable remuneration will bear on the solution.

Non-degree research fellowships (and scholarships)

The primary purpose of the non-degree provision of Section 117(b)(2) seems to be to provide a limited exclusion from income of such foundation grants as the Guggenheim Fellowships.[10] This seems evident from the restriction requiring that the grantor be a Section 501(c)(3) charity or governmental unit. Broadly, the usual grant in such cases seems to be made to a post-doctorate recipient carrying on research. That this was the thought of the Senate Finance Committee is indicated in their illustrations of the application of the $300–36 month rule.[11] Therefore, such fellows are not bound by the requirement of attendance at a Section 151(e)(4) institution.[12] Nor are such grants in terms subject to the "part-time employment" limitation of Section 117(b)(1); this is explicitly stated to be the case in the Senate Report.[13]

It would seem, however, that employment may well rear its ugly head under Section 117(b)(2) in what appears to be its most serious interpretative problem. For example, the Ford Foundation (or the recipient's school) makes a grant of expenses and an amount measured by

[1] See *e.g.*, CHOMMIE, *Federal Income Taxation: Transactions in Aid of Education*, 58 DICK. L. REV. 93 (1954); Note, *Scholarships, Fellowships and Prizes: Gift or Income?* 38 MINN. L. REV. 152 (1954).
[2] H. REP. No. 1337, 83rd Cong., 2d Sess., 3 U. S. CONG. NEWS 4041 (1954).
[3] See CHOMMIE, *Payments to Employees: Gifts or Compensation for Services?* 31 TAXES 620 (1953).
[4] Section 151(e)(4).
[5] S. REP. No. 1622, 83rd Cong., 2d Sess., 3 U. S. CONG. NEWS 4823 (1954).
[6] *Id.*, originating in H. REP. No. 1337, *supra* note 2.
[7] Robertson v. United States, 343 U.S. 711 (1952), holding that a prize in a musical composition contest was taxable income because it was in discharge of a legal obligation, a payment in return for services rendered and therefore in "no sense a gift."
[8] P-H 1952 T.C. Mem. Dec. Par. 52140, following Ephraim Banks, 17 T.C. 1386 (1952).
[9] I.T. 4056, 1951-2 CUM. BULL. 8.
[10] After the passage of the 1954 Code the Tax Court, in full court review, seems to reject the Commissioner's position in I.T. 4056, *id.*, that such grants are taxable. George Winchester Stone, Jr., 23 T.C. 254 (1954), appeal dismissed, 4th Circuit, March 28, 1955, holding a Guggenheim Fellowship excluded as a gift, five judges dissenting. See also Ti Li Loo, 22 T.C. 220 (1954).

the recipient's salary to a professor to conduct a year's research in a foreign country. No rights or benefits are retained by the grantor. Is the first $300 a month excluded under Section 117(b)(2)? It is clear that the Ways and Means Committee was concerned with avoidance in this respect in stating that "amounts received as grants which in effect represent a continuing salary during a period while the recipient is on leave from his regular job"[14] are not to be excluded. However, the technique used was to deny the exclusion unless the annual amount of the fellowship was less than 75% of the previous 12 months' earned income. The Senate rejected the House formula in substituting the Code provision requirements of a charitable grantor and the $300—36-month limitation. While these limitations may effectually block salary-continuation plans if the grantor is a taxpaying unit, the literal language of Section 117(b)(2) would seem to permit a violation of the spirit of the exclusion, as in the above example. Such cases, while not serious from the standpoint of the revenue, do point up the necessity for careful draftsmanship to avoid excluding amounts which are really only normal income.

Further, without ascribing a lower tax morality to educational institutions than to the average citizen, perhaps it can be anticipated that there will be attempts to re-label paid assistantships, or some of the work of the instructional staff, as research or teaching fellowships. Similarly, there may be attempts to abuse the exception to the employment limitation of Section 117(b)(1). Here we can guess that substance will control form, and that any marked change in school policy in this respect will certainly run the risk of being overruled.

Amounts excluded under Section 117 (a)(2)—actual expenditures for travel, research, clerical help, and equipment—are not included in applying the $300 a month limitation. However, the Service seemingly will interpret this exclusion strictly. It has ruled recently that no allowance will be made for additional amounts received because the recipient has dependents.[15]. Because of this strict attitude, institutions which make a lump-sum grant after an application has listed amounts for living expenses, travel, and other Section 117(a)(2) items[16] might well, where the grant approaches $300 a month, state separately the Section 117(a)(2) items in order to secure the maximum benefit under Section 117(b)(2).

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What Congress has done under the 1954 Code is little more than to change the focus of attention in this area from donative intent to employment. Under the 1939 Code there was no attempt to reach scholarships or fellowships not requiring services on the theory that they were donative in character. The 1954 Code pursues the same course based on an even more inarticulate policy expression. In the interpretative arena, moreover, it is difficult to see how "the existing confusion" has been alleviated. Under the 1954 Code tax counsel, the Treasury, and the courts will still be forced to examine in detail all the terms of a grant and the circumstances.

The boldest change from the old law has been with the new treatment of research fellowships. Here there has been an ostensible abandonment of both donative intent and employment. On the other hand, the simple technique of requiring a Section 501(c)(3) grantor and the $300—36-month rule suggests that this also will breed litigation. While arbitrary exclusion may well be dictated by the policy considerations involved, the provision as it stands would seem to permit unequal treatment of researchers, whether full or part-time, vis-á-vis their more fortunate colleagues who are Section 117(b)(2) fellowship recipients.

Perhaps what is needed is Congressional review of the policy considerations and articulate expression justifying a more equitable application of Section 117 as regards both degree candidates and research fellows. ☆

[11] S. Rep. No. 1622, *supra* note 5, 3 U. S. Cong. News 4824 (1954). The extent of exclusion provision, § 117(b)(2)(B), provides that the general exclusion of § 117(a) is "limited to an amount equal to $300 times the number of months for which the recipient received amounts under the scholarship or fellowship grant during such taxable year, except that no exclusion shall be allowed under subsection (a) after the recipient has been entitled to exclude under this section for a period of 36 months (whether or not consecutive) amounts received as a scholarship or fellowship grant while not a candidate for a degree at an educational institution (as defined in section 151(e)(4)." The Senate Report illustrates the application of § 117(b)(2)(B) thusly:

"(1) In March of the taxable year the taxpayer is awarded a post-doctorate fellowship grant which is to commence the following September 1, and is to end on June 1 of the following year. The amount of the fellowship grant is $4500, and the taxpayer receives this amount in monthly installments of $500 on the first day of each month. During the taxable year he receives a total of $2000 with respect to the 4 months of September through December, inclusive. He may exclude $1,200 from gross income in the taxable year, and must include the remaining $800.

"(2) Assume the same taxpayer as in the preceding example, except that he receives the full amount of the grant ($4,500) on September 1 of the taxable year. Since the amount received in the taxable year was for the full term of the fellowship (9 months), the taxpayer may exclude from gross income in the taxable year $2,700. The remaining $1,800 must be included in gross income.

"(3) The 36-month limitation in subsection (b)(2) applies if the individual has received amounts excludable from gross income under subsection (2) attributable to any prior 36 months (whether or not consecutive) during which the individual was not a candidate for a degree. For example, if the taxpayer received under a fellowship grant $200 a month for 36 months he would have exhausted his eligibility under subsection (b)(2) even though he did not in any of the 36 months make use of the full $300 exclusion."

[12] A grant to a degree candidate at an institution outside the definition of § 151(e)(4) literally would seem to fall outside the limitations of both §§ 117(b)(1) and (2). In such rare instances perhaps the governing criteria would be that of § 102(a) excluding gifts from income, or in general the approach taken under the 1939 Code. Similarly, in case of a non-degree grant by one not falling within the definition of a charity under § 501(c)(3), as, for example, a grant by an individual or a private corporation. Quaere as to whether corporate educational grants to children of employees should not be treated as taxable fringe benefits.

[13] S. Rep. No. 1622, *supra* note 5, 3 U. S. Cong. News 4823 (1954).

[14] H. Rep. No. 1337, *supra* note 2, 3 U. S. Cong. News 4041 (1954). See also the detailed illustrations of the application of the 75 per cent rule in connection with salary continuation transactions of private employers.

[15] Rev. Rul. 55-554, 1955-35 Int. Rev. Bull. 8.

[16] See *e.g.*, the Guggenheim Fellowship grant and application set out in George Winchester Stone, Jr., 23 T.C. 254 (1954).

New case adds confusion to taxability of income from gift subject to loan

When we discussed the tax position of a person who makes a gift of property-subject-to-a-loan a few months ago (4 JTAX 24) we had a storm of comment from practitioners who reported that the Treasury was reconsidering its position. We had pointed out the chance that one might realize income by making a gift of property subject to a loan, and having the donee pay off the loan.

Now we have a case which doesn't jibe with the Treasury's theory. In *Herff*, noted below, the Tennessee District Court found that the taxpayer had income, but on a rationale which if applied in the more usual case of a gift of the entire property (Herff retained a life interest in the property, a residence) would save the donor from tax.

The ruling we referred to in January (and we have seen others like it which practitioners had obtained) concerned a taxpayer who owned securities for which he paid $1,000, now worth $3,000. He borrows $1,000 on the stock and gives it to the charity, which assumes the debt

and pays it. The IRS position was that the donor would realize ordinary income in an amount equal to the excess of the liability assumed over the portion of his $1,000 basis allocable to the liability. The value ot the stock was $3,000, the liability $1,000 and the donor's equity $2,000. Deducting 1/3 of the basis or $333 from the $1,000 liability gives $667, the amount of the ordinary net income.

Now the *Herff* case is somewhat different from the one above. The usual case is a donor of appreciated securities who would like to make a gift of part of their value and borrows to retain part, perhaps their original cost. What Mr. Herff did was to buy property and mortgage it completely (thus in effect recovering his outlay). Then he gave the University not only the remainder interest in the property but also cash equal to the mortgage. Comparing Mr. Herff's position after these transactions with his position prior to them, he gave away cash equal to the mortgage but obtained a life interest in the property. Only the mortgage payment by the University after it received the property was in issue in the case. The court found the taxpayer received income because he realized an economic gain insofar as the mortgage on the retained life estate was extinguished.

But the usual donor of mortgaged property doesn't retain a life estate or other interest. It would follow on this theory that he receives no income when his beneficiary pays off the debt.

Here is what the court said in finding that Herff realized income:

"A correct solution of the problem presented would appear to lie in a determination of the legal relationship existing between the parties as a result of the transfer to Southwestern of a remainder interest in the property 'subject to' the lien indebtedness. It is undeniable that Southwestern did not assume personal liability. But it does not follow from that fact that the plaintiff, if he had been compelled to pay the indebtedness, would not have had recourse for reimbursement against the remainder interest in the property which had been conveyed to Southwestern . . .

". . . If property at the time of conveyance is encumbered by a mortgage and is conveyed subject to the mortgage, the apparent intention of the parties, in the absence of language indicating a contrary purpose, is to continue the mortgage lien in the same status which it occupied before the conveyance, with the result that the property itself remains as the primary security for the indebtedness.

"In the instant case while Southwestern incurred no personal liability there is nothing to indicate that the parties did not intend the limitation 'subject to' to have the effect of continuing upon the remainder interest conveyed to Southwestern its pro rata share of the liability for payment and discharge of the lien indebtedness. So viewing the transaction, if plaintiff had been compelled to pay the entire debt himself, he would have had the right to obtain reimbursement on a pro-rated basis, not against Southwestern personally, but against the remainder interest in the property. To that extent he was a surety; and to the same extent the payment of the indebtedness by Southwestern resulted in no income to him. By the same token, to the extent that the payment of the lien indebtedness by Southwestern discharged the lien upon the life estates which were retained by the plaintiff, he realized an economic gain or benefit. As to that portion of the payment an indebtedness upon his own estate was cancelled or extinguished, and if he had made the payment himself he would have had no right of recourse as he was not a surety." ☆

New decisions affecting individuals

Amended decree required alimony for limited period; contingency of remarriage or death makes it deductible. Taxpayer was divorced in 1946 under a decree providing for the periodic payment of alimony until his wife died or remarried. In November, 1947, the decree was altered to provide that payments would cease in September, 1954, if the wife remarried in the meantime. The wife remarried in December, 1947, and the Commissioner contended that that fixed a principal sum to be paid off by September, 1954, and the taxpayer was not entitled to any further alimony deductions. Not so, says the court. In the first place, the determination of a principal sum must be computable on the date of the decree and not arise as a result of later acts such as this remarriage. Furthermore, the contingency of death still existed and no principal sum could be computed. *Burton,* DC Utah, 2/17/56.

Payments on a lump sum for less than 10 years not taxable to the wife. Taxpayer was divorced from her husband on February 8, 1945. A settlement agreement adopted in the decree provided for the payment of $87,000 "payable in periodic installments during a period ending more than ten years" later. Following out the specific terms of the agreement, however, results in the lump sum being paid off in less than ten years. The court holds that the conflict in the agreement must be resolved in favor of the specific provision over the general statement. The installments were not, therefore, taxable income to the taxpayer. *Lehmann,* DC Ill., 3/8/56.

Divorce decree altered to combine support and alimony as alimony; payments thereafter fully deductible. Taxpayer's 1940 decree provided for the payment of $100 a month alimony and $400 a month for the support of their children. A 1942 order provided for the payment of a fixed monthly amount without allocation between the wife and children, but granted the taxpayer the right at any time to go back to making payments under the 1940 decree. In 1944 and 1947, additional altered decrees required taxpayer to make unallocated monthly payments, with no right to revert to the terms of the 1940 order. The terms of the later orders clearly indicated that the parties considered that all of the payments would be taxable to the ex-wife. The Commissioner contended that the monthly payments under all of the decrees had to be apportioned between the wife and children in the same ratio as was provided in the original 1940 order, and the Tax Court had sustained him on the ground that no intention to alter that allocation was shown. This court holds for the Commissioner with respect to payments under the 1942 alteration, because taxpayer had the right to revert to the 1940 terms at any time. With respect to payments made under the 1944 and 1947 decrees, however, taxpayer was entitled to the full deduction. These decrees by their terms clearly indicated that no allocation was intended. *Joslyn,* CA-7, 3/12/56.

Payments under oral agreement (later written) deductible as alimony. Prior to taxpayer's divorce in 1940, he entered into an oral agreement with his wife to

pay her $50 a week for the rest of her life, to be reduced to $25 if she remarried. The divorce decree was granted on the grounds of the wife's adultery and declared forfeit all of the wife's rights of dower, homestead, and alimony. Taxpayer later remarried and shortly thereafter in 1945 he and his former wife reduced their oral agreement to writing. The payments were held in discharge of a marital obligation under "a written agreement incident to divorce" and the payments thereunder were deductible. Six dissents: The Illinois decree cut off the wife's right to support or alimony, hence the obligation to pay was not founded on a marital obligation prerequisite to deductible alimony. *Fixler,* 25 TC No. 157.

Can't deduct support to deserted wife; not alimony. The life beneficiary of a spendthrift trust deserted his wife. The trustees were subsequently directed by court decree to pay the wife $7,000 a year as support monies. Inasmuch as the decree was not a decree of separate maintenance but was a decree merely enforcing the husband's marital duty to support his wife, the husband is not allowed to deduct the payments as alimony. *Moorhead,* TCM 1956-67.

Uncle Sam won't finance doctoral degree. A research associate at the University of Hawaii sought to deduct expenses incurred in obtaining his Ph.D on the theory that the degree was an essential requirement for a permanent staff position. He argued that his case was similar to *Hill,* 181 F.2d, 906, in which a schoolteacher was allowed the expense of summer school required to continue her existing position. The court pointed out that when taxpayer here took the job it was required that he finish the work for his Ph.D. The court said the degree was a prerequisite in his field. The expenses were clearly for "commencing" and not for "carrying on" or "preserving" his status, and as such were nondeductible personal expenses. *Kamins,* 25 TC No. 144.

Part of farmer's expenses for personal use. A farmer maintained a garden plot on his farm, and in addition to the garden vegetables raised some chickens and livestock for his personal use. A disallowance of $1,000 of farm expenses for each of the taxable years was held proper as representing expenses attributable to produce personally consumed. *Nowland,* TCM 1956-72.

No deduction for legal and accounting expenses paid on behalf of stockholders. Taxpayer-corporation paid legal and auditing expenses in connection with the investigation and litigation of the income-tax liabilities of its two controlling stockholders relating to certain transaction by them while members of a predecessor partnership. Taxpayer failed to prove that it assumed the personal tax liabilities of the partners at the time it acquired the partnership assets; the payments are held to be voluntary and not deductible as ordinary and necessary business expenses. *Harrison Lumber & Hardware Co.,* TCM 1956-59.

Unreimbursed business expenses allowed; sale of lots denied capital-gains treatment. In an extremely brief statement of facts and conclusion of law, the court holds that taxpayer was entitled to deduct amounts claimed as unreimbursed business expenses for the years in question and was denied long-term capital-gains treatment on sales of certain lots. *Coleman,* DC Ky., 3/23/56.

No loss for slow-eating termites. Taxpayer inspected his home in 1948 and found no termite damage. In 1952 he discovered extensive termite infestation and damage. The court held there was no showing of suddenness in the destructive process sufficient to support a casualty deduction. *Dodge,* 25 TC No. 114.

Congressmen pay tax on full salary; portion returned to U. S. is a contribution. Where a Congressman returns a portion of his salary, the full amount of the salary is includible in his gross income and is subject to withholding tax, while a deduction is allowable as a charitable contribution for the amount returned to the Treasury. *Rev. Rul.* 56-126.

Can deduct part of theatre benefit admission as a contribution. The portion of the admission charge to a motion-picture exhibition staged to raise funds for a charity which exceeds the normal admission charge to that motion picture is deductible as a charitable contribution and is not subject to the admissions tax. *Rev. Rul.* 56-120.

Hospital pathologist not an independent contractor; can't take business expense and standard deduction. Taxpayer was employed during the taxable year by two hospitals as a pathologist at a substantial annual salary plus a small percentage of the fees charged by the hospitals to out-patients for his work. The great bulk of his work was compensated for by his salary and consisted of pathological and laboratory services rendered to the in-patients of the hospitals at the request of and in consultation with the physicians and surgeons practicing in the hospitals. The court holds taxpayer was an employee, not an independent contractor. He could not claim expenses of his "business" and also the standard deduction. The only deductions an employee not an outside salesman may take in computing adjusted gross income are reimbursed expenses and travel, meals, and lodging away from home. *James,* 25 TC No. 154.

Real-estate man's wife had ordinary income on sale of houses; she acted through him as agent. The court found that taxpayer was in the business of dealing in real estate and realized ordinary income. Though not personally active, her numerous ventures amount to a business conducted through an agent—her husband and his employees. Affirmed on appeal. *Shepherd,* CA-6, 2/15/56.

Salary not constructively received: checks were not to be cashed. [*Acquiescence*] In October, 1949, taxpayer and three others, the officers, stockholders, and board of directors of a corporation, received salary checks which they all agreed were not to be cashed until the president decided that the corporation's financial position warranted payment. The restriction was not removed, and no payments on the checks were made in 1949. The court held that the salary was not unqualifiedly subject to taxpayer's demand and disposition and therefore was not constructively received for that year. *Johnson,* 25 TC No. 62, *acq.* IRB 1956-15.

Beneficiary can't take trust losses. Taxpayer, a life-income beneficiary of an irrevocable trust, without powers to modify, revoke, or terminate the trust, claimed on her individual income-tax return a loss incurred by the trust. Pointing out that she made no argument to show why she considered the Commissioner to be in error, the court sustains the deficiency. *Reeves,* TCM 1956-76.

TAX STRATEGY NEWS OF THE REVENUE SERVICE

Effective tax procedures

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Recent cases focus attention on extent to which a ruling from the IRS is binding

A SERIES OF CASES decided since the beginning of 1956 point up the problem of the legal effect of Internal Revenue rulings. The *Avco Mfg. Corp.*, the *Automobile Club of Michigan*, and *Crosley* cases, all discussed herein, permitted the retroactive revocation of rulings ostensibly on the ground that there had been a mistake of law. Actually, each is a case of second sight and new statutory construction. What is happening to the policy of the IRS to stand behind its rulings?

What is a ruling?

The term "ruling" is used to describe a written statement issued by the Commissioner, or under his authority, upon the request of the taxpayer seeking to learn the tax consequences of a completed or executory transaction, "and is intended to serve the purpose of establishing principles and policies of the Service in the interpretation and application of the substantive tax law." Reg. 601. 201 (a) (2). The Code provides for the formalization of such ruling by a "closing agreement," Sec. 7121. The issuance of either type of ruling is within the discretion of the Commissioner, Sec. 7121 (a); Reg. 601.201 (a) (1); Reg. 601.201 (d); Reg. 601.202 (a) (1). A closing agreement, however, is final and conclusive, in the absence of fraud, malfeasance, or misrepresentation of a material fact. Sec. 7121 (b); Reg. 601.202 (a) (1). A case closed by agreement may not be reopened or modified by the taxpayer or the Commissioner or set aside in any suit, action or proceeding. Sec. 7121 (a); Reg. 601.202 (a) (1). The finality of these agreements has repeatedly been upheld by the Courts. *United States v. Bank of Commerce & Trust Co.*, 32 F. Supp. 942 (D.C. Tenn. 1940), aff'd. 124 Fed. 187 (CA-6 1942); *Wolverine Petroleum Corp. v. Commissioner*, 75 F. 2d 593 (CA-8, 1935), certiorari denied 295 U.S. 743; *Herring v. Tait, Collector*, 65 Fed. 703 (CA-4, 1933). However, if the agreement relates to an executory transaction, it is "subject to any change in or modification of the law enacted subsequent to the date of the agreement . . .". Reg. 601.202 (a) (2).

Effect of rulings under new law

Rulings have always been deemed to be without legal effect and the regulations under 1954 Code for the first time so provide. Reg. 601.201 (i) (1). They further provide that such rulings may be reviewed from time to time and modified or revoked if they are found "to be in error or no longer in accord with the position of the Internal Revenue Service." Reg 601.201 (i) (2) (3) and (4). The Code [Sec. 7805 (y)] authorizes the Commissioner to apply rulings, regulations or Treasury decisions retroactively. Reg. 601.201 (l) (4) provides:

"However, it is the general policy of the IRS to limit the revocation or modification of a ruling issued to or with respect to, a particular taxpayer to a prospective application only if (i) there has been no misstatement or omission of material facts, (ii) the facts subsequently developed are not materially different from the facts on which the ruling was based, (iii) there has been no change in the applicable law, and (iv) such taxpayer acted in good faith in reliance upon such ruling and a retroactive revocation would be to his detriment."

While this section embodies the various tests heretofore applied by the courts in determining the finality of rulings, it omits the test of mistake of law. Reg. 601.201 (i) (4) (iii) tests binding effect by determining whether or not there has been a change in the law. Will a change in the law be construed to include a new interpretation of the law?

Although the "rulings" within the purview of this comment are written, some word about oral advice given to the taxpayer by IRS personnel seems in order. The pertinent regulation [601.201 (h)] provides that such advice is considered only an aid to the taxpayer. It carries no weight. The court decisions are to the same effect. *Darling v. Com'r.*, 49 Fed. 2d. 111 (CA-4, 1931); *Binder v. Welch*, 107 F. 2d. 812 (CA-9, 1939).

Although the regulations on the binding effect of rulings are new, they merely embody the policy of the IRS which has long been that such rulings are without legal effect. Yet in spite of this policy, only a very small percentage of all rulings issued have been "closing agreements." The faith evinced in the informal rulings can, however, be justified by the taxpayers' experience with such rulings. Once issued they are almost invariably followed as a matter of administrative policy. This accounts for the fact that while over 50,000 "ruling letters" are issued a year, an insignificant number of these rulings are involved in litigation. See "Operation of the Taxpayers' Ruling Section", M. W. Kriegh, New York University, 10th Annual Institute on Federal Taxation, 1952."

Courts find rulings not binding

The courts have for the most part followed the view of the IRS that taxpayers' rulings are not binding. In the famous *James Couzens* case, 11 BTA 1040 (1928), the Commissioner ruled on the valuation of stock prior to sale. After the sale was consummated in reliance on the ruling, it was later reversed retroactively. The taxpayer contended that the Commissioner was estopped.. The Board held that there was no estoppel, "because such valuation was neither authorized nor intended to be binding and there was no necessary or justifiable reliance thereon." The same year, *Woodworth v. Kales*, involving the same stock valuation as the *Couzens* case, was decided by the 6th Circuit, 26 F. 2d 178 (CA-6, 1928). There the taxpayer paid the tax under protest and sued for a refund in the District Court. The court held that there was an estoppel and furthermore that a new valuation could not be fixed as a result of "a matured and better judgment" in the absence of a claim of fraud or mistake of law or fact. The same view was taken in the more recent case of

HSD Co. v. Kavanagh, 191 F. 2d 831 (CA-6, 1951) where the reversal of a ruling on the basis of different inferences from the same facts was held to be indefensible.

The "mistake of law"

In keeping with the above cases, a mistake of law is always held to justify a retroactive reversal. *Avco Mfg. Corp. v. Commissioner* decided by the 6th Circuit on Jan. 31, 1956. The ruling there had held that the reorganization involved was tax-free. The *Automobile Club of Michigan* case decided by the same circuit on Feb. 17, 1956 was to the same effect. The question involved was whether or not the Automobile Club was a social club. The court found that there was no estoppel. The petitioner also contended that he was entitled to tax exempt status under the case of *Helvering v. Reynolds Tobacco Co.* 306 U.S. 110 (1939). It was held that the gain secured by a corporation on the sale of its stock in 1929 should be governed by the regulations in force in 1929 rather than the amended regulations. In other words, retroactive application of Treasury amendments were not permitted. In the *Automobile* case, the regulations remained unchanged but the court held that they would not be given effect, where the premise upon which their applicability was based was false. The dissent, however, pointed out:

"It is not every ruling based on a mistake of law, that may be afterward subject to so-called correction by the Commissioner with retroactive effect. Where the construction of a statute by a former Commissioner has not been plainly erroneous, or in conflict with express statutory provisions, a succeeding Commissioner may not revoke the former ruling with retroactive effect."

See also: *Maryland Casualty Co. v. United States,* 251 U.S. 342, 349 (1920); *Walker v. United States,* 83 F. 2d, 103, 107 (CA-8, 1936); *Crucker v. Lucas,* 37 F. 2d 275 (CA-9, 1930). Actually, what the dissent is saying here is that rulings must not be reversed "on matured and better judgment" alone, as was held in the *Kale* case. That, in effect, is all most of the so-called mistakes of law amount to. In the *Automobile Club* case a dozen years after the original ruling, a new Commissioner wrote the Club that the Bureau was reconsidering the question of the exemption of automobile associations in the light of the opinion of the chief counsel. It then proceeded, as the dissent points out, to take the same facts, law, and regulations and come up with a different statutory construction, correcting its former "mistake of law."

Where the taxpayer instead of the government has sought to retroactively reverse a ruling, on the ground of an erroneous interpretation of the law, he too has succeeded. *Richard K. Mellon,* 12 TC 90 (1949). To the same effect is the recent case of *Crosley Corp. v. United States,* decided by the 6th Circuit on Jan. 25, 1956. There it was said that a deduction incorrectly taken by a taxpayer as a business expense instead of a capital allowance can be corrected, even though offsetting corrections in earlier returns are barred by the Statute of Limitations.

Disavowal when facts not disclosed

It has also been held that the Commissioner might reverse himself retroactively, where the facts had not been fully disclosed to the Bureau at the time the request for the ruling was made. So in *Md. Agricultural Fair Ass'n.,* 40 BTA 549 (1939); *Overbey v. United States,* 44 F. 2d 268 (Ct. Cls. 1930), where a ruling was issued on a hypothetical set of facts and subsequently reversed the court stated, "We are not persuaded that the ruling made by the former Commissioner covered the precise facts in the case." *Arthur H. Lamburn,* 13 BTA 177 (1928). To stave off reversal of rulings, in addition to setting forth all material facts, it has been suggested that the taxpayer promptly consummate the proposed transactions. Delay may change the factual situation submitted. It may also give the IRS time to decide that its ruling is erroneous and if the taxpayer has not yet acted to its detriment, it may reverse. See "Taxpayers' Rulings," J. P. Wenchel, 5 *Tax Law Rev.* 105 (1950).

When the Commissioner or his agents make a determination or a ruling, they are acting as an administrative tribunal and exercising functions of a quasi-judicial nature. The fruits of their labors should therefore possess the quality of finality, barring fraud, concealment or a patent mistake of law. The dissent in the automobile case cites *Rock Island A. & L. Railroad Co. v. United States,* 254 U.S. 141 (1920) where Justice Holmes said, "Men must turn square corners when they deal with the government"; it also cites *Howbert v. Penrose,* 38 F. 2d 577 (CA-10, 1930), which added "The government ought to turn square corners when dealing with its citizens." In *Stockstrom v. Commissioner,* 190 F. 2d 283 (CA-D.C. 1951) it was held that the commissioner might not reverse his determination on the ground that "one may not found a claim upon an admission which he himself induced." The court added, "It has been well said the government should always be a gentleman. Taxpayers expect and are entitled to receive ordinary fair play from tax officials." ☆

IRS increases number of pamphlets, rulings, published

THE TECHNICAL SERVICES DIVISION of IRS is increasing gradually the number of assistance pamphlets and rulings, being published each year. This year, in addition to the very popular *Your Federal Income Tax,* the IRS put out a *Farmers' Tax Guide.* The students' tax course goes to an increasing number of secondary schools each year, and projected for 1957 is a small pamphlet to help Congressmen and other elected officials determine the various types of expenses that are deductible.

The Service also is trying to publish more rulings. More are published each year, but the number could usefully be increased, the IRS feels. Only about one-third of the Regulations needed under the 1954 Code have been issued so far, and preparation of the rest will add materially to the department's workload.

Growth of publication activities is hampered by the fact that about ¼ of the 400 technicians involved are eligible for retirement, and that many of those remaining are becoming increasingly valuable to outside law firms and accounting firms. It takes at least six months, and often a year or more, to train adequately replacements for those who leave, which results in a smaller flow of new material than is desirable.

New decisions

Tax Court upheld in refusing continuance. Taxpayer's case was listed for trial in December 1952. Continuance was granted to May and then again to September, when he was warned no further delay would be granted. On the afternoon of the day prior to that set for

trial taxpayer first consulted counsel. The judge insisted on trial and this court holds there was no abuse of discretion. Taxpayer has no one but himself to blame for his difficulties. *Woodbury,* CA-3, 3/21/56.

No 3801 adjustment for gain on security sale though inconsistent with acquisition which had been ruled tax-free. [*Acquiescence*] In 1934, 1936, and 1937, taxpayer sold securities it had acquired on an exchange in 1931. It reported the 1931 acquisition as taxfree, and when the Commissioner asserted it was taxable (he valued the securities received at $20) paid the tax and sued for refund, which it received in 1941. However, in reporting the sales it used the $20 basis, proper only if the exchange were taxable. The Commissioner attempted to open 1934, 1936, and 1937 on the ground that taxpayer's treatment was inconsistent with the determination in the 1931 case. The court holds, however, that the district court did not determine basis in the 1931 case, nor was the later omission "in respect of any transaction on which basis depends." *American Foundation Co.,* 2 TC 502, *acq.* IRB 1956-15.

870 doesn't bar later refund suit (old law). The executor of taxpayer-estate signed a Form 870 accepting a compromise valuation of stock and agreeing not to bring suit for refund. Subsequently he filed a claim for refund based on other matters. The court holds that the only statutory closing agreement is one signed by the Secretary of the Treasury; the 870 here was not so signed, therefore it bound neither the government nor the taxpayer. This suit brought by the legatees under the will is not foreclosed because they did not file a claim for refund; they were the real parties in interest and can use the executor's claim. [The 1954 Code provides that a closing agreement may be executed by a delegate of the Secretary. *Ed.*] *Miller Estate,* DC Wisc., 2/16/56.

Consent judgment in Tax Court stands despite pressure through jeopardy assessments. Taxpayer asked that his authorization of entry of a consent judgment in the Tax Court be set aside because his consent was forced by the financial pressure on him due to jeopardy assessments of tax due. The court refuses to go along with this proposal. *Funkhouser,* CA-4, 11/7/55.

Tax Court's 3-year delay between hearing and decision not error. [*Certiorari denied*] The Tax Court had found taxpayer failed to include over $200,000 paid directly to him by customers buying pens from his partnership. It also sustained fraud penalties. Though deploring the delay, this court finds it not reversible error, even though the decision turned largely on credibility of witnesses. *Starr, cert. den.,* 3/26/56.

Overstatement of costs results in omission of income. Taxpayer improperly included cost of a water-pumping station as a cost of lots sold [see page 335. *Ed.*]. This overstatement of costs was an omission from gross income of an amount in excess of 25% of the gross income reported. Accordingly, the 5-year statute of limitations applies. *Colony, Inc.,* 26 TC No. 3.

If closing inventory incorrect, need not open next year with same error. Taxpayer, a farmer, showed a closing inventory of $6,850 on his 1947 return and an opening inventory of $28,000 on his 1948 return. The court found the 1948 opening figure properly computed under the "farm-price method" and concluded the error occurred in 1947. As there was no omission from gross income in 1948, the Commissioner could not make an assessment under the five-year statute of limitations. *Page,* TCM 1956-61.

Can redetermine income for loss carryover from closed year. Taxpayer sustained a net operating loss for 1947 and carried it back to 1945. The Commissioner recomputed the 1945 income after the statute of limitations had run on that year, thereby reducing the available carryback to 1946. The court disagrees with the taxpayer's contention that the expiration of the statute of limitations is a bar to a redetermination of the 1945 income. The Commissioner cannot impose an additional assessment for a closed year but he is not barred from recomputing income in determining the correct tax for another year. *Phoenix Coal Co., Inc.,* CA-2, 3/13/56.

Claim barred by the statute of limitations allowed as an amendment of prior claim for different year. Taxpayers incurred a net operating loss in 1946 and filed a timely claim for refund of 1945 taxes based on the carryback. After the time for filing a claim had expired, they realized that the 1946 loss had to be carried back to 1944 first. Taxpayers then filed what purported to be an amendment of their previous claim, and asked for a refund of 1944 taxes. The Commissioner contended that the 1944 claim was filed too late and could not be related back to the 1945 claim. In a liberal opinion, the court holds that the 1944 claim qualified as a proper amendment because the original claim put the Commissioner on notice of all of the appropriate facts and would have required an investigation of the 1944 return before any decision could have been reached. *Ryan,* DC Ill., 3/8/56.

Evidence sufficient for fraud conviction. Taxpayer, a buyer for a used-car concern, was convicted for not reporting as income in 1947 kickbacks received on the purchase of cars. On appeal, he contended that the admission in evidence of the sellers' envelopes indicating the kickbacks and of the taxpayer's 1946 tax return was improper. The court holds that both pieces of evidence were properly admitted. The envelopes are business records and the 1946 return was related to the intent in connection with the crime charged. *Brewster,* CA-2, 3/22/56.

Agent can summon taxpayer's attorney and attach accountant's worksheets in attorney's possession. [*Certiorari denied*] The court upholds an agent's right to issue a summons to the attorney representing a taxpayer under investigation. The courts have long upheld this procedure though it is not authorized as such in the statute. This court agrees with the district court's finding that certain worksheets prepared by taxpayer's accountant, though in the attorney's possession, were the property of the accountant. Hence these records are not protected by the attorney-client privilege. *Sale, cert. den.,* 4/3/56.

Commissioner's recomputation of income incorrect; taxpayer's stands. The Commissioner had determined taxpayer's receipts from the sale of liquor for the years of 1943-46 by applying a markup formula to purchases. In a prior opinion the Tax Court ordered receipts to be recomputed by multiplying the number of bottles purchased by 22 drinks per bottle, and that total by the selling price per drink. But as taxpayer submitted such a recomputation for 1945 only, the court upheld the Commissioner's use of the markup method for the other years. On appeal, the Sixth

Circuit reversed on the ground that the markup formula did not clearly reflect receipts, therefore the Tax Court erred in upholding it. On remand to the Tax Court, the taxpayer and the Commissioner both stated there was no evidence to permit recomputation of 1943, 1944, and 1946 receipts under the "drinks-per-bottle-purchased" method, and the court therefore sustains the amounts reported by taxpayer for those years. *Gasper,* TCM 1956-78.

Gain reported as capital not omitted from return. The Commissioner assessed additional tax more than three years after taxpayer filed his return. However he claimed taxpayer omitted 25% of gross income reported by showing gain or liquidation of a corporation as capital and eliminating 50% of it in the computation. The court says that if a taxpayer discloses gross income in his return he does not omit it. The five-year statute of limitations, applicable if the omission had been made, cannot be used. *Hommes,* DC Calif., 3/1/56.

1954 and 1955 Form 1120's wrong in limiting dividends received and paid credits if alternative capital-gains tax applies. The 1954 and 1955 forms for corporate income tax provide that when certain dividend-received and -paid credits are limited to a specified per cent of net income, that income does not include capital gains taxed under the alternative tax method at 25%. This, the Service announces, was wrong; the capital gain should be included in income. The credits to which this rule applies are: 85% of dividends received from domestic corporations; dividends received from foreign corporations engaged in U. S. business; dividends received on certain public-utility stocks; certain Western Hemisphere and China Trade Act corporation credits; certain dividends paid by public utilities. *Rev. Rul.* 56-151.

No intent to file a joint return. Taxpayer's return was in form a joint return. His wife's name was signed by his secretary without the wife's knowledge or consent. The return did not include income attributable to the wife (she had no income other than a few prizes won by entering contests). The court held there was no intent to file a joint return and the wife was therefore not liable for deficiencies. *Ringler,* TCM 1956-77.

Wife not liable on joint return if never intended as such. [*Acquiescence*] Taxpayer's wife was not liable "jointly and severally" for the deficiency even though the return on its face purported to be a joint return. She did not intend to file a joint return, the signature was not hers, and she never knew the return had been filed. *Helfrich,* 25 TC No. 51, *acq.* IRB 1956-15.

Wife liable for penalty for husband's fraud on joint return. A return signed by husband and wife included the income and deductions of each spouse, which were listed in separate schedules attached to the return. The court holds it to be a joint return on which the wife is individually liable for tax and penalties resulting from her husband's fraudulent acts. *Hughes,* 26 TC No. 2.

Gift to daughter while insolvent not fraudulent; taxes not yet due. In July of 1943, taxpayer's father gave her $20,000, which was reported on a gift-tax return subsequently filed. The gift was made while the father was insolvent; however, he was not yet liable for 1943 income tax. In 1948, the Commissioner assessed a 1943 deficiency against the father of nearly $65,000, based on the disallowance of a bad-debt deduction, and attempted to collect it from the daughter. The court finds that the Commissioner had not sustained his burden of proving that the gift was made with fraudulent intent. The gift was reported openly to the government, and on the facts the court cannot draw the conclusion that taxpayer's father intentionally claimed a bad-debt deduction knowing that it was not allowable. *Peckham,* DC Ohio, 2/14/56.

Purchase of stock by another stockholder really liquidation; seller liable as transferee. Taxpayer was a minority stockholder of a corporation in which her husband owned 98.9% of the common and 69.1% of the preferred. In 1945 the husband decided to retire and had the corporate assets sold. In the following year he withdrew $75,000 from the corporation which he deposited in his personal account, and on the same day he gave taxpayer his check on that account for $53,600 in return for her stock. That sum was equal to the par value of her preferred plus dividend arrears, and the book value of her common holdings. Taxpayer is held liable for unpaid corporate taxes as transferee to the extent of $53,611; the payment to her was in the nature of a corporate liquidating distribution, which left the corporation without means to pay its taxes. *Benoit,* 25 TC No. 79.

Donee liable for donor's income tax; gift made after jeopardy assessment. After they received a jeopardy notice for unpaid taxes, taxpayers conveyed $14,000 in cash to their minor son. The transfer was held invalid under state law, having been made with intent to defraud the U. S. Accordingly the son was liable as transferee even without a showing that his parents were insolvent at the time of the gift. *Fried,* 25 TC No. 145.

Waiver is not bar to refund claim by taxpayer until Commissioner accepts it. The executors signed the IRS standard form of Waiver of Restrictions Against Assessment and Collection of Deficiency in Estate Tax consenting to the assessment of a compromised amount of tax. This form expressly states that it is subject to acceptance by the Commissioner. The Commissioner failed to formalize the agreement; it was signed only by the head of the Technical Staff. It follows that the government is not bound. Therefore, the court holds, the taxpayer is not bound. The executors may sue for a refund. *Alexander Estate (Bennett, Exec.),* CA-7, 4/4/56.

Taxpayers estopped from breaking their agreement after the statute had run against the government. In a family-partnership case, a settlement was reached after concessions by both parties, and a Form 870 containing an agreement by the taxpayers not to file any claim for refund was signed. The settlement was for 1946 and 1947. After the statute of limitations for assessment of a 1946 deficiency had expired, but before the 1947 period had run, the taxpayer filed a claim for refund. The court holds that the agreement in the Form 870 bound neither party, because under the Code only an agreement signed by the Secretary of the Treasury is a real closing agreement. However, the government relied on the 870 in allowing 1946 to expire and under the doctrine of equitable estoppel, the taxpayer could not claim a refund of the 1946 taxes after the statute had run against the government. This not being the case with respect to 1947, the refund claim was valid. *Schneider,* DC Minn., 2/10/56.

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The Internal Revenue Service has made it clear that all qualified trusts must file, annually, Form 990-P. This may be filed on either a calendar or fiscal year basis as such accounting year is established by the trust. If the employer has filed the information required by Regulations 1.404(a) the trustee is relieved of this duty.

The reason for the Commissioner's insistence that Form 990-P be filed is made clear by the questions on page 1 of the form. Question 6 is for the purpose of determining whether or not the trust has engaged in any unrelated business transactions, which may result in taxable income to the trust. If the trust has engaged in such transactions the next question (7) asks if the required Form 990-T has been filed. Question 8 is for the purpose of determining whether or not the trust has engaged in any of the "prohibited transactions" as set forth in Section 503 and commented on above.

If the answer to any part of question 8 is "yes," then the trustee must be in a position to furnish additional information that may be required, and specifically, if the answer is yes to (a), (d), or (e) the trustee is required to furnish specifically required information with respect to the financial candition and earning capacity of the employer, with reconciliations of changes in such statements. In addition, information with respect to the assets of the trust and amounts invested in the stock or securities of the employer, or a corporation controlled by the employer, is required. ☆

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